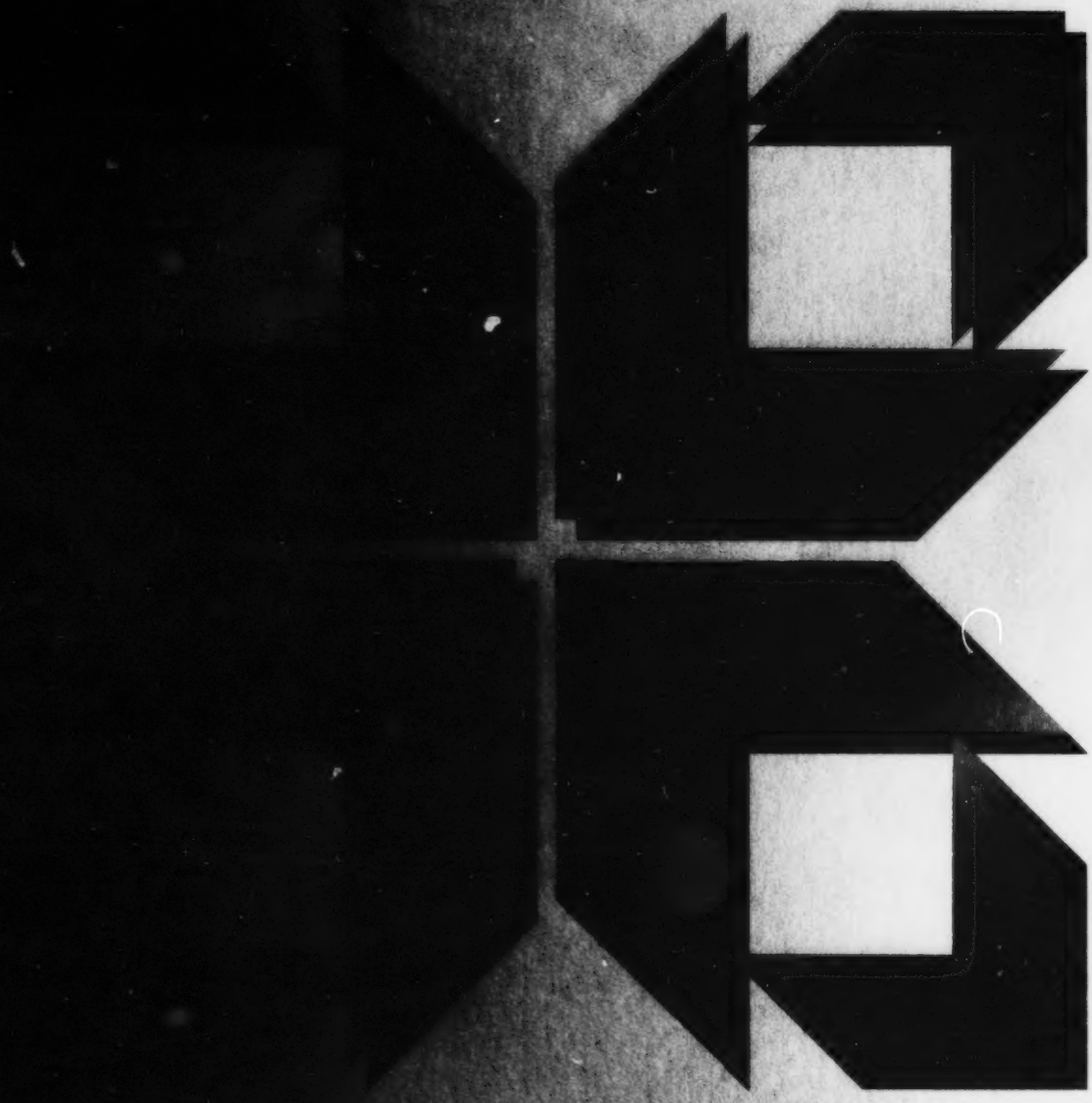
A New Frontier

Globalization and Canada's Financial Markets



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This Statement reflects the views of the Members of the Economic Council of Canada; however, a dissent from Recommendation 16 by Thomas Courchene, endorsed by Marcel Pepin, appears at the end of the document.

Members of the Economic Council of Canada

Judith Maxwell, Chairman
Caroline Pestieau, Deputy Chairman and Director
Harvey Lazar, Deputy Chairman and Director

Miller H. Ayre
President and Chief Executive Officer
Ayre's Limited
St. John's

Diane Bellemare
Professor
Département d'économique
Université du Québec à Montréal
Montréal

Jalynn H. Bennett
Vice President, Corporate Development
The Manufacturers Life Insurance Company
Toronto

Alan A. Borger
President
Ladco Company Limited
Winnipeg

Jacques Bougie
President
Alcan Enterprises
Montréal

Dian Cohen
President
Dian Cohen Productions
Toronto

Thomas J. Courchene
Professor
Department of Economics
Queen's University
Kingston

Léon Courville
Executive Vice-President
National Bank of Canada
Montréal

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Vancouver

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President
Groupe Sobeco Inc.
Montréal

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Koskie & Minsky
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Toronto

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Faculty of Management
University of Manitoba
Winnipeg

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President
Nelson Lumber Co. Ltd.
Lloydminster, Alberta

Constantine E. Passaris
Professor
Department of Economics
University of New Brunswick
Fredericton

Marcel Pepin
Professor
École de Relations industrielles
Université de Montréal
Montréal

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Vice-President, Investor and
Industry Relations
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Montréal

H. Graham Wilson
Vice-President and Secretary
Dofasco Inc.
Hamilton

Foreword

The 1980s will be remembered as a decade that brought various parts of the world closer together through such developments as the trade agreement between Canada and the United States, the building of the single European market, and the emergence of stronger economic ties between the countries of the Pacific Rim. Nowhere is the movement towards globalization of the world economy more evident than in the financial sector. The integration of financial markets across the world and the associated financial innovation have brought fundamental changes in the way financial institutions operate, in the way funds are raised, and in the kinds of financial instruments used.

The Economic Council has, for many years, taken a strong interest in the operations of the Canadian financial system. In 1976, we published a major report on the regulation of banks and other deposit institutions. This was followed in 1982 by a report on the role of government in Canadian financial markets.

This is the second Statement on Canada's financial markets to be released by the Council within the last two and a half years. In *Competition and Solvency* (published in November 1986) and its companion research report, *A Framework for Financial Regulation* (released in March 1987), we presented an in-depth analysis of Canada's financial institutions and markets, as the long-awaited overhaul of domestic regulation got under way. In its 1986 Statement, the Council offered recommendations aimed at increasing competition in the domestic market, improving the access of Canadians to efficient financial services, and buttressing the solvency of their financial institutions. In the present Statement, we go a step further by analysing the performance of Canada's financial system in the context of the internationalization of financial markets and financial innovation – two developments that have increased in momentum and significance in recent years.

Internationalization and financial innovation may, at first, appear to be of only distant concern to many Canadians. Our research has shown, however, that they have a direct impact on the well-being of Canadians in all walks of life. They open up new opportunities for Canadian financial institutions; they give Canadian borrowers access to new pools of money in ways that are better tailored to their needs; and they enable investors to diversify their portfolios better. As borrowers and investors are themselves producers of goods and services, these developments reduce their operating costs and thus strengthen their competitiveness.

Our research also shows that internationalization and the development of new instruments make it much more difficult to track financial transactions, to identify the parties to financial trades, and to assess the risk exposure of various participants in financial markets – institutions or individual borrowers or investors. This has a potentially negative impact on the stability of both international and domestic financial markets.

The recommendations put forward here seek to find a balance between opening up Canadian financial markets to international competition, promoting access to financial services across the country, and maintaining the solvency of financial institutions and the stability of financial markets. This was also the thrust of the recommendations in our previous

Statement on financial markets. Thus the 23 recommendations offered in this Statement complement the 31 recommendations contained in *Competition and Solvency*.

The project was directed by André Ryba, of the Council staff. The team was assisted by an advisory committee, composed of three Council members and four outside experts, two of them from large international institutions. The committee, which was chaired by Alix Granger, a Council member, provided valuable guidance to the research team in setting the overall direction of the project and in evaluating the research results. On behalf of the Council, I would like to thank the members of the advisory committee for their valuable contribution to the Council's research effort, as well as the staff, for their diligence and care.

The team faced the challenge of capturing in an analytical way a rapidly evolving situation. The scope of its work is reflected in the detailed research report entitled *Globalization and Canada's Financial Markets*, which is to be published later this year. Members of the team travelled to Europe, the United States, and Australia, as well as here in Canada, conducting more than 250 interviews with representatives of financial institutions, corporations, regulators, and policy makers. In addition, a database was acquired from a British publishing company, providing detailed information on individual issues in the Eurobond market (since 1963) and in the market for shorter-term notes (since 1981). The research team reformulated the data in order to analyse the participation of Canadian borrowers in international markets, compared with borrowers in other countries, and to measure the market share of Canadian financial institutions in the management of international securities issues. Data were also obtained from corporations, governments, trade associations, and financial institutions themselves.

Since the release of *Competition and Solvency*, financial regulation and government policies have generally evolved – albeit at a slow pace – in the direction recommended in that document. We are encouraged by the progress to date, but further changes should be implemented soon. We believe that the recommendations in this Statement will help to fashion a financial framework that will provide Canada and Canadians with the tools to build a strong future in an increasingly integrated world.

Judith Maxwell
Chairman

A New Frontier

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

..	figures not available
...	figures not appropriate or not applicable
--	amount too small to be expressed
-	nil or zero
e	estimated figures
x	data confidential, to meet the secrecy requirements of the *Statistics Act*.

Details may not add up to totals because of rounding.

Introduction

In recent years, financial markets have undergone a massive transformation. When rapid change occurs on such a dramatic scale in any sphere of activity, those who had grown accustomed to the old conditions are suddenly cast into the situation of pioneers entering unfamiliar territory. They must learn to adapt quickly to the new terrain. Even though they have no maps to guide them, they must do their reconnaissance without delay, identify the new opportunities that are present, and try to avoid the pitfalls that inevitably lie ahead. Those who adjust quickly to the new frontier move forward; those who are slow to learn fall behind.

Canadians have entered such a new frontier – a global financial market, where innovative products have shattered the traditional ways of doing business. Traders operating through modern telecommunications from many parts of the world, and foreign institutions recently established in Canada, now offer financial services to Canadians in direct competition with domestic chartered banks and securities firms. For their part, Canadian financial institutions offer many similar services to customers in New York, London, Sydney, or Hong Kong. These developments have brought some benefits to Canadians, and they have the potential to offer more. But they have also helped to erode many of the traditional safeguards of the Canadian financial system.

Thus, for borrowers and lenders, and for governments and regulators, there is a need to chart the new terrain. For the most part, the systems needed to manage the changes have not been developed, either domestically or internationally. Until they are, Canadians will be unable to avail themselves fully of the benefits of participating in the new financial markets – benefits that would ultimately be reflected in lower costs for the production of goods and services, increased competitiveness in international markets, and higher living standards. To do nothing would leave Canadians exposed to many of the risks that accompany increased international transactions and innovative instruments but without the tools necessary to manage them safely; to do nothing would also mean that Canadians would forgo many of the added benefits that are currently within their reach.

Our Statement is in four parts:

– In Part 1, we describe the stages of the dual process of internationalization and innovation, and we set out the broad framework of our analysis.

– In Part 2, we examine the extent of the globalization of financial markets and the emergence of new instruments and practices. We describe the opportunities that these developments offer, the risks that they entail, and the reactions of the regulatory authorities. We argue that internationalization and innovation offer ways of transacting financial business that are more efficient than those which existed previously – and that they are therefore here to stay.

– Part 3 is devoted to an analysis of Canadian participation in international markets and in the process of financial innovation. It focuses on the role played by Canadian-controlled institutions and examines the implications of these new developments for certain long-standing debates in domestic public policy. In analysing globalization and innovation, we found that large Canadian corporations, both private and public, are aggressive users of international markets but that small and medium-sized businesses are not yet reaping the benefits of these recent developments. We were also surprised to discover that, in some respects, Canadian banks and securities firms are lagging behind their counterparts in other countries. And it became clear that globalization and innovation impose new imperatives on the current efforts of the federal government and the provinces to modernize their regulatory systems.

– Accordingly, in Part 4 we offer proposals on how Canadians – and especially their governments – can meet the challenges posed by internationalization and innovation.

Readers already familiar with the new financial environment may wish to turn directly to Parts 3 and 4, where we examine the domestic policy issues and set forth our recommendations.

The detailed analysis underlying Parts 1 and 2 of the Statement will be found in the companion research report, entitled *Globalization and Canada's Financial Markets*, to be published within a few months. Among the topics in the Statement that will be expanded upon in the research report are: the financial industry in Canada (Chapter 2); innovation in the financial sector (Chapter 3); the internationalization of financial markets (Chapter 4); the presence of foreign institutions in domestic markets (Chapter 5); and the coordination of financial regulation at the domestic and international levels (Chapter 6).

Readers will find at the end of the present Statement a glossary of technical terms that will guide them through the jargon that is commonly used in today's financial markets.

1 Changing Times

The internationalization of financial markets is the result of a number of related factors. Perhaps the single most important has been the dismantling of many of the barriers to the free flow of capital that had been erected by governments in the 1930s. The removal of those barriers was itself facilitated by the collapse, in the early 1970s, of the Bretton Woods Agreement, under which national governments had been committed to a system of fixed exchange rates.

Another factor has been the sweeping regulatory changes that have occurred in many industrialized countries during the 1970s and early 1980s. Examples are numerous. In the United Kingdom, the "Big Bang" in 1986 opened up the London securities market. In France, interest-rate ceilings, foreign-exchange controls, and impediments to the development of new instruments and practices were gradually removed during the 1970s. In Japan, the liberalization of the yen led to the opening-up of domestic financial markets to new instruments, new competition, and international activity.

The economic situation of the 1970s reinforced these longer-term structural factors. The growing external imbalances between nations helped to spur the internationalization process. The two oil shocks of the 1970s, the Third World debt crisis of the early 1980s, and more recently the combination of large surpluses in Japan and West Germany and large deficits in the United States – all called for the international recycling of funds. Skyrocketing interest rates and exchange-rate volatility served as strong incentives for the international diversification of investment portfolios and sources of funds.

The globalization of financial markets has been accompanied by a rapid increase in the development and use of new financial instruments and new practices for managing risks, broadening markets, and improving access to funds. Financial innovation has facilitated that process and has been stimulated by it. The introduction of new financial instruments has also been driven by the increased volatility of exchange and interest rates that followed the collapse of the Bretton Woods Agreement and the worsening imbalances between creditor and debtor nations.

These changes in financial markets did not take place in isolation. They are only one aspect, triggered in part by a relaxation of protectionist regulations, of a wider movement towards the global integration of economic and other activities – and particularly of production systems – with multinational companies operating plants throughout the world for customers who are also from every corner of the planet. Partly, too, the new global reach of financial activities has been facilitated by the conquest of time and distance through the adoption of new technology, particularly in telecommunications. For example, the SWIFT system, which is used to transmit international payment instructions, carried about 800 banking transactions on its first day of operation in May 1977; 10 years later, it could handle 900,000 such transfers daily.

In trade, there has been a similar process of integration, with previously separate markets being consolidated into trading blocs. The Canada-U.S. Free-Trade Agreement – the first-ever binding accord covering bilateral trade in financial and other services – is among the most recent of these developments. Although the agreement does not harmonize the financial regulations of the two countries, it does represent an important step forward in the internationalization of financial services. It allows the banks and other financial institutions of one country to operate in the other under the regime known as "national treatment" – that is, under the regulatory framework that applies to the host country's domestic institutions.

Potentially even more momentous is the evolution of the European Economic Community towards full market integration. Under the current schedule, by the end of 1992 the 12 member countries of the Community will become a single market of 320 million people, within which individuals, goods, services, and capital will be able to move almost as freely as they do within their respective nations today. Thus a giant new economic bloc is poised to emerge, with uniform taxation rules, product standards, and accounting systems, and with common processes of financial intermediation. In this integrated Europe, a bank or securities firm based in any member country will be able to set up operations in any other member country. A company listed on one stock exchange will almost automatically obtain a listing on any other stock exchange within the Community.

The transformation of world financial markets has profound implications for Canada, for it will affect directly the provision of financial services to its residents. The institutions that supply those services are part of our daily environment, whether in our personal lives or in our working activities. For individuals and businesses, they provide loans, insurance, deposits, and other investment facilities, as well as a mechanism for cashing cheques and transferring funds. They also facilitate the issuing and purchase of securities, such as bills, bonds, and stocks. At present, 87 per cent of adult Canadians have at least one savings account; 32 per cent hold shares in caisses populaires or credit unions; and 60 per cent have life insurance policies. Between 1982 and 1986, financial institutions helped Canadian businesses raise

$21 billion a year, on average, in the form of various types of debt instruments and equity. That amount represented about 38 per cent of their sources of funds.

Another important function of the system is the dissemination of financial information. Financial institutions provide intelligence for investors and borrowers about the investment climate and the economic outlook, and about the investment potential of various stocks and the variables that affect the present and future value of assets.

The financial system also has a broader influence on our lives. It is the machinery through which funds are channelled from investors to borrowers and, ideally, from those who are less able to sustain risk to others who are more able to do so. The efficiency of the financial system affects the cost and uses of money; as a result, it also affects the pace of industrial development and the value of the Canadian dollar – and, ultimately, the length of the "Help Wanted" section in our daily newspapers.

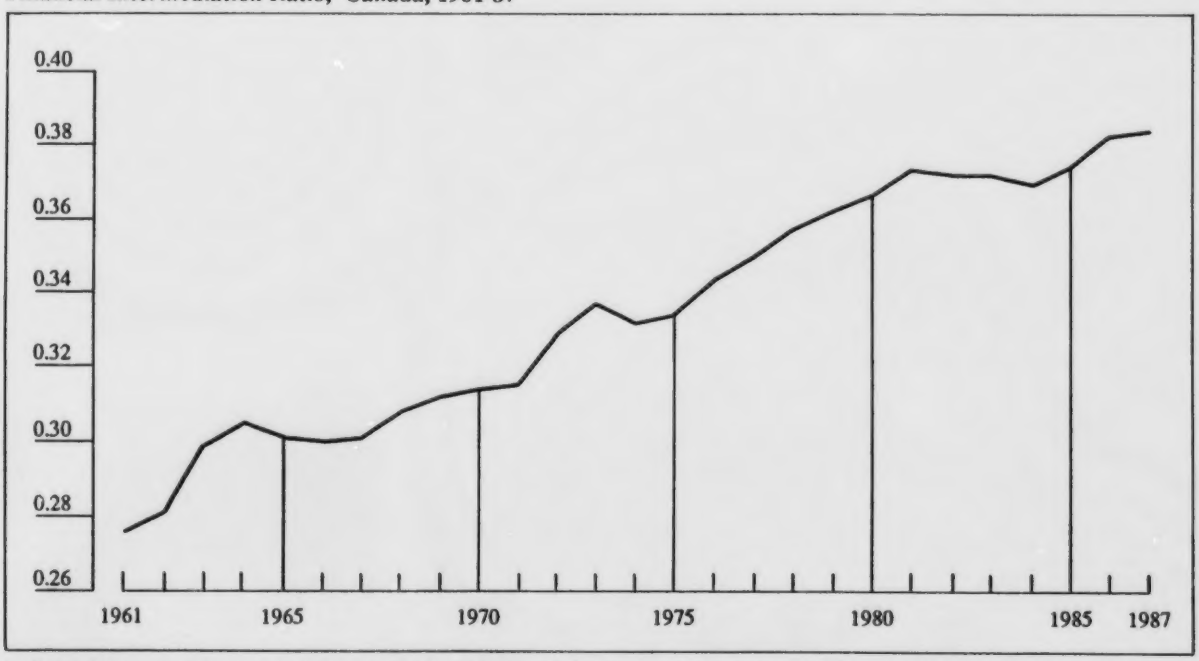
Throughout the world, financial markets are growing relative to the size of the underlying economy. In the United States, Japan, West Germany, and Canada, to take a few examples, the assets of financial institutions and the bond market have grown faster than the overall economy for at least 10 years. Households, corporations, and governments are increasingly turning to financial markets for their borrowing and investing needs, and financial assets are being traded more often.

There has also been a rise, in recent years, in the proportion of financial activities channelled through financial institutions – in what has been called the "institutionalization" of financial markets. In Canada, the ratio of the assets of financial institutions to total financial assets in the economy increased significantly during the period 1961-87 (Chart 1).

Thus it is clear that the efficiency of financial markets and financial institutions is everyone's concern. It matters to the consumer and to the homeowner, as well as to the person who launches a new business or to the chief executive officer of a corporation. An efficient financial system is an important means of promoting the economic well-being of the nation. In turn, the efficiency of financial markets and institutions is determined by three interacting factors:

Chart 1

Financial Intermediation Ratio,[1] Canada, 1961-87



1 Ratio of the assets of financial institutions to total financial assets in the economy. A rise in the ratio indicates that the importance of financial institutions in the conduct of Canada's financial transactions has grown.

SOURCE Based on data from Statistics Canada.

– the extent of competition within the financial system;

– the accessibility of financial services to both borrowers and lenders; and

– confidence in the system and in the solvency of the institutions that comprise it.

The degree of *competition* within the financial industry affects the range of services and products that it provides, as well as their price and their quality; and, other things being equal, the greater the competition, the better the users are likely to be served. The *accessibility* of these services and products to different categories of users is helped by competition but is not guaranteed by it. It is relevant to consider whether, and to what extent, financial services and products are available under the same conditions to small users as to large ones, and to consumers outside the larger urban centres and outside central Canada, relative to those living in or near the country's financial centres. Confidence in the *solvency* of institutions and the stability of the underlying payments system are also basic to the efficient operation of the financial system. In the absence of a large measure of trust, many business transactions that could best be handled through financial intermediaries either will not proceed or will proceed but at a higher cost.

Both internationalization and innovation have significant implications for competition, accessibility, and solvency. The competition between institutions of different countries for the same business is now far greater than it was even just a few years ago. That competitive environment creates new opportunities for the users of financial services, and it seems likely to do so even more in the future. Financial innovation, by the very nature of the new products and processes it has provided, has contributed to this increased competition. Certain categories of borrowers, however, have enjoyed greater access than others to the new services and products.

Solvency considerations are also affected by internationalization and innovation. On the one hand, shocks are easily transmitted from one financial centre to another – from New York to London, from Hong Kong to Tokyo, from Singapore to Sydney. And on the other hand, both the global spread of markets and the appearance of hundreds of new financial products have rendered inadequate the traditional methods of enhancing solvency.

Thus the changes that have taken place in financial markets as a result of internationalization and innovation have produced both gains and losses in the factors that determine efficiency. Gains in competition sometimes increase the risk of insolvency and add to systemic risk – that is, the risk of instability attached to the financial system itself. They can also benefit some categories of users while, at least in a relative sense, having a harmful effect on others. The role of public policy is to ensure that the best possible balance will be struck between competition, accessibility, and solvency.

2 New Markets, New Products

The internationalization of financial activities and the emergence of a large number of new financial products are the two major trends that have transformed financial markets over the past decade or so. Here we examine the nature and extent of the internationalization of financial markets, the role of the new financial instruments, and the benefits and costs attached to those two developments.

Internationalization

Nature

There is nothing revolutionary *per se* about such developments as the internationalization of financial markets, the increase in cross-border capital flows and geographically diversified portfolios, or even the penetration of domestic markets by foreign banks and securities firms. What is new about the current wave of globalization is its scale and speed, and the way it has transformed the behaviour of investors, borrowers, and corporate managers. It has expanded their horizons to the point where today their market options are worldwide in scope and their financial decisions are based on global considerations. The Canadian company seeking funds for expansion no longer turns automatically to Canadian sources of capital: its choice is just as likely to be the London, Tokyo, or New York market – or even a Swiss investor.

The adoption of a global perspective is not confined to corporations and institutions. In considering the state of their portfolios, many individual investors today also look at foreign opportunities. In all major industrialized countries, people and institutions know that they must be attuned, not only to domestic developments but also to events and influences throughout the world whose impact can be transmitted within seconds to the local scene.

Extent

The extent to which borrowers and lenders in all countries have switched from domestic to international financial transactions in the past decade or so is truly remarkable. The change can be quantified in terms of:

- the increased volume of cross-border capital flows;
- the increased volume of international issues of securities;
- the penetration of domestic markets by foreign financial institutions;
- currency diversification; and
- the rise of financial centres.

Cross-Border Capital Flows

Cross-border capital flows have expanded dramatically over the past decade. For Canada, cross-border trade in existing – as opposed to new – securities increased 21 times between 1978 and 1988, with most of the increase having taken place after 1983.

The funds raised on international bond markets by all countries in 1986 were six times higher than the amount recorded in 1980. Over the same period, the volume of activity increased by a factor of somewhat less than three in the U.S. and French domestic markets, by a factor of two in the Japanese market, and by less than 50 per cent in the Canadian market (Chart 2). While there was some slowdown in international markets in 1987 as a result of turbulent conditions on the bond and stock markets, the level of activity has since bounced back.

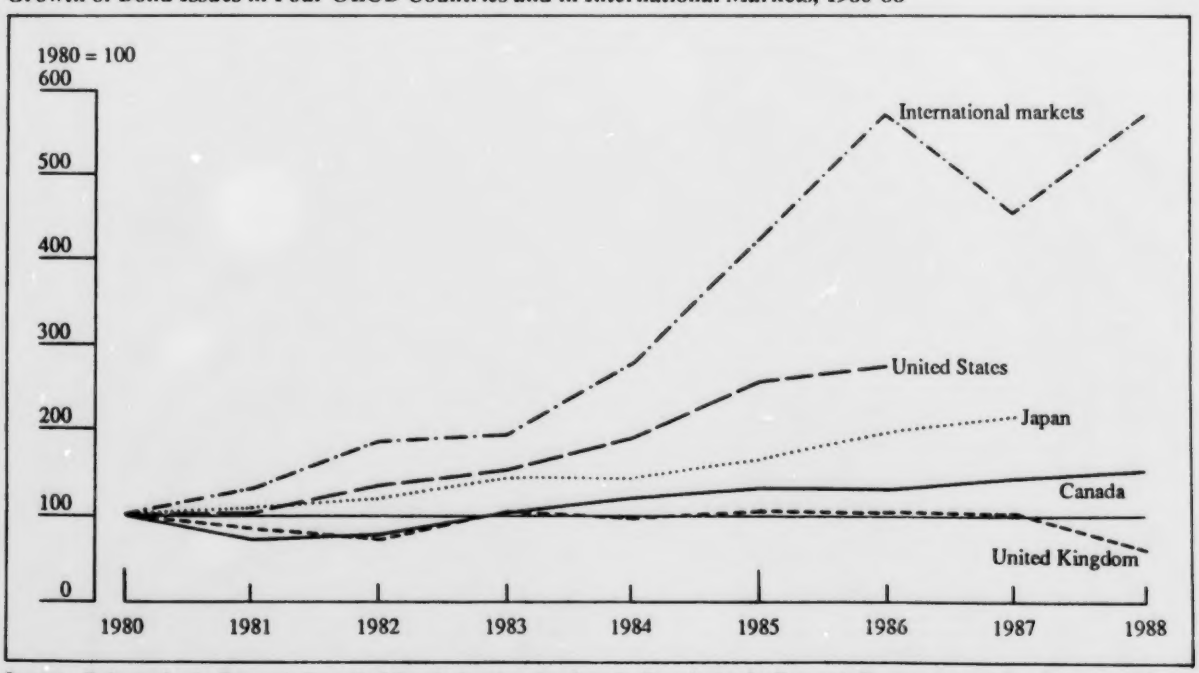
The growth in the volume of funds raised on international markets was accompanied by a dramatic shift away from traditional bank lending and towards "securitized" forms of lending such as bonds, notes, and short-term paper (Chart 3). For the banks, that shift was marked by more reliance on fee income and less on the more traditional spread between lending and borrowing rates. In addition, the banks have increasingly become involved in securities trading.

International Issues

In 1970, a total of 126 issues of international bonds – i.e., bonds sold simultaneously in two or more countries – were

Chart 2

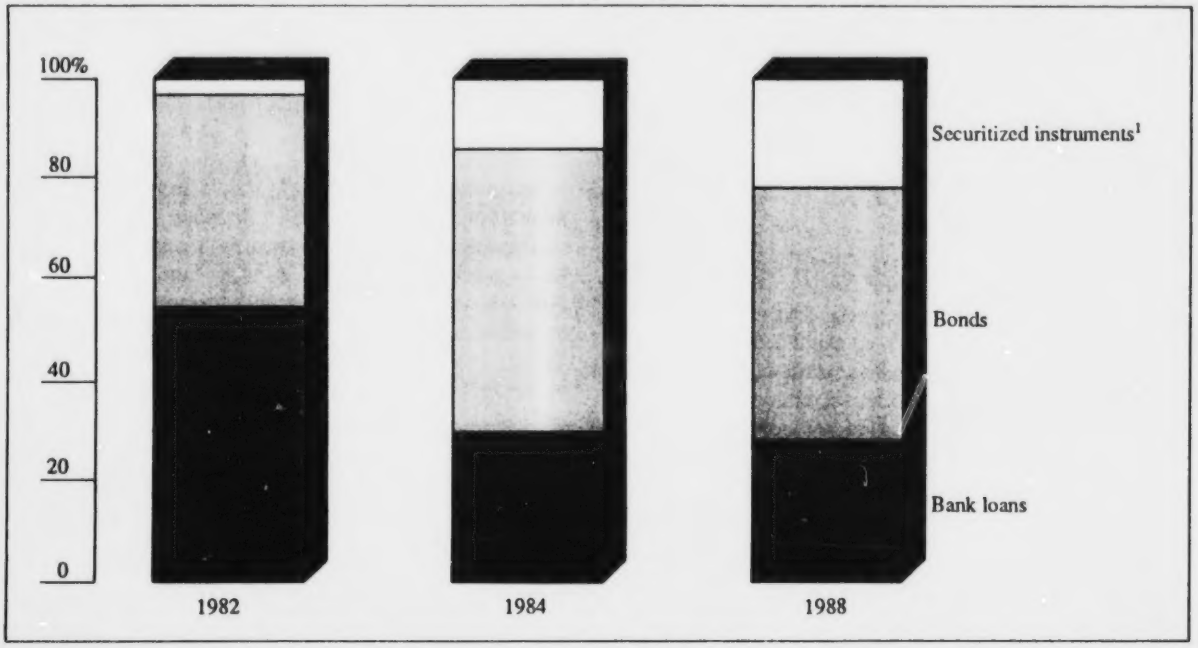
Growth of Bond Issues in Four OECD Countries and in International Markets, 1980-88



SOURCE Estimates by the Economic Council of Canada, based on data from the Organisation for Economic Co-operation and Development and from the Bank of Canada.

Chart 3

Distribution of Funds Raised on International Markets, by Category of Instrument, 1982, 1984, and 1988



1 Includes note-issuance facilities, Euro-commercial paper, other borrowing facilities, and international equities.
SOURCE Based on Organisation for Economic Co-operation and Development, *Financial Market Trends*, various issues.

floated by 104 issuers; by 1988, those figures had jumped to over 1,500 issues involving just under 700 issuers.

The intervening period had also seen a rapid expansion in the trading of foreign equities on the world's stock exchanges. In Tokyo, where growth was the swiftest, the volume rose from US$35 million in 1980 to US$391 million in 1984, then exploded to over US$24 billion in 1987.

Penetration of Domestic Markets

Not so long ago, many banks and other institutions channelled their international financial transactions through institutions abroad with which they had a working relationship. Funds could be transferred between institutions by mail or by telex. More recently, however, the trend has been for financial institutions to establish a physical presence in the countries where they do a substantial proportion of their business.

In 1960, for example, there were 51 foreign banks in the United Kingdom, accounting for over 6 per cent of total banking assets; recent figures show that the number of foreign banks operating in Britain had risen to 368 in 1987 and that their assets accounted for 62 per cent of the total. That same year, Citibank, one of the largest institutions in the United States, was present in 90 countries throughout the world. As for Canadian banks, they are now established in over 50 countries; and there are 57 foreign-bank subsidiaries in Canada. Over half of the life insurance companies operating in Canada are foreign institutions; Canadian life insurance companies, for their part, also have extensive operations abroad.

Currency Diversification

In 1981, 81 per cent of international bond issues were denominated in U.S. dollars; by 1988, that share had declined to 41 per cent. Over the same period, the share of the Japanese yen rose from 1 to 9 per cent. There are, however, fluctuations in the use of various currencies. With changing circumstances, some currencies become more attractive while others have become less so. Thus the Canadian dollar has increased in popularity over the very recent period. Before 1987, its share of the international bond market rarely rose above 4 per cent, but in 1988 that figure exceeded 7 per

cent. What is important, here, is that lenders and borrowers are willing to use whatever currency is most advantageous for them – a strong indication that the market has become truly global in scope.

The Rise of Financial Centres

Another important feature of the internationalization process has been the concentration of financial activity in three major international centres – London, New York, and Tokyo. In those three cities are found the command posts, the decision-making centres of international finance. Because they are several time zones apart and because they are connected electronically, many kinds of transactions can go on 24 hours a day. For example, several institutions pass their inventory of securities (or "the book") – currently limited mainly to U.S. Treasury Bonds – from one centre to the next. At the opening of the market in Tokyo, traders can deal, within certain parameters, out of the closing inventory of securities in New York. At the end of their trading day, they will pass along their closing positions to their colleagues in London.

Benefits

The globalization of financial markets has been driven by the needs of both borrowers and investors. For borrowers – corporations and governments alike – the quest for the cheapest sources of funds and for a broadening of their borrowing base has been paramount. For savers and portfolio managers, the incentive has been better investment opportunities and greater diversification of portfolios. All of these considerations have also driven financial institutions to adopt a more global view of their operations.

For financial institutions, the benefits of internationalization can be impressive. A freer flow of capital across borders means new opportunities for the enterprising firms. It enables them to diversify their services and to expand into markets beyond their national borders. When they establish branches and subsidiaries abroad, they can have better and quicker access to information, and thus are better able to capitalize on opportunities and to manage risks.

Naturally, the benefits are greater for some than for others. Large corporations and governments can exploit these opportunities directly, but few, if any, individuals or small companies can do so at present. Moreover, surveys in the United Kingdom and the United States indicate that small and medium-sized businesses may have lost some advantages because of internationalization and financial innovation. With tougher competition, the banks have had to be more careful in pricing the various services that they offer. Small and medium-sized firms have thus lost some of the benefits that they enjoyed previously as a result of internal cross-subsidization by the banks, and their costs have risen. Herein lies one of the challenges for government policy: to determine whether, and to what extent, the benefits enjoyed by large customers as a result of globalization can also be made available to small and medium-sized firms at a reasonable cost.

From the point of view of the world economy, globalization promises a better allocation of savings and investment. As barriers fall, savings will flow more easily from countries with a surplus of capital to those where it is in shortage. In brief, capital will go where it will receive the highest return, taking into account such risk factors as exchange-rate fluctuations and interest-rate differentials.

Risks

Increased benefits are rarely free. Costs of some sort are usually attached. In financial markets, they can take the form of institutional and systemic risks. And indeed, the changes that have occurred recently have modified the nature of the risks, both for the institutions themselves and for the financial system as a whole.

For financial institutions, the movement into foreign markets has brought a different mix of risks than those to which they were accustomed in domestic markets. These traditional risks were associated mainly with the creditworthiness of borrowers and with interest-rate fluctuations. Now, however, the institutions are more vulnerable to the possibility that political, legal, or economic factors in the host country may damage their interests. In their foreign operations, they must often rely heavily on funding from large institutional deposits, since they do not normally enjoy the same access to retail deposits in foreign countries as they do in their domestic market. Because large institutional deposits tend to be much more footloose than retail deposits, the institutions face a greater risk of a sudden loss of deposits in their foreign operations than they do at home. The firm that conducts business in international markets must also deal more heavily in foreign currencies, and that makes it more vulnerable to exchange-rate fluctuations.

For the financial system as a whole, the internationalization of markets has brought about a decline in transparency, as it is more difficult to follow and monitor cross-border flows and to obtain information on the counterparties to international transactions. Moreover, with the growing

integration of financial markets, the effects of an "accident" of local origin can be felt almost instantaneously around the world. The integration of markets has also heightened the impact of the Third World debt crisis. By the mid-1980s, the intensity of that crisis had reached the point where the whole financial system appeared vulnerable to a default by a major debtor nation. That danger has been reduced over the past few years, with most institutions setting aside large reserves to protect themselves – and the system of which they are a part – against the possibility of a default.

Impact on the Conduct of Macroeconomic Policy

The present Statement is mainly concerned with the operations of financial institutions and markets, and focuses on microeconomic issues. We recognize, however, that internationalization also has other important implications, especially for the conduct of macroeconomic policy. We have discussed these macroeconomic issues in other reports, and we shall undoubtedly do so again in future publications. In this Statement, we touch on them only briefly.

Dealing first with fiscal policy, there is a concern that internationalization may have contributed to a lack of discipline in the matching of government spending and revenues. When the possibility of financing public deficits was largely determined by the availability of funds in domestic markets, governments were generally running lower deficits than is the case today. In more recent times, however, they have found it easier to raise money in international markets, and they have been less concerned with the crowding of private-sector borrowers out of domestic markets, since those borrowers have also gained easier access to sources of funds overseas.

Indeed, it may appear to some that the world is now able to live with larger imbalances than before the days of accelerating internationalization, as the large government deficits of the 1980s have yet to result in a strong resurgence of inflationary pressures, in levels of interest comparable with those of the late 1970s, or in a recession. Even if that assessment were correct, however, complacency would be unwarranted. Once the new opportunities afforded by easier access to foreign sources of capital have been exhausted, there will be nowhere else to go. At that time, the effects of fiscal imbalances will inevitably be felt; and since the size of the imbalances that will need to be corrected will be greater than it would otherwise have been, the needed adjustments will also have to be larger.

A second effect pertains to the conduct of monetary policy. With internationalization, investors have become less concerned about whether their investments are held in U.S. dollars, Japanese yen, Deutschemark, Swiss francs, or any other currency. Assets are thus becoming more substitutable, and capital is moving more easily across borders in response to even modest interest-rate differentials. The net effect has been a narrowing of those differentials between countries. As a consequence, interest rates have become a less viable channel for the conduct of monetary policy; indeed, the major impact of monetary policy in the short term now works through changes in the exchange rate. For Canada, the impact of the trend towards globalization on monetary policy is small, simply because Canada has always been open to international financial flows and because Canadian and U.S. financial assets have been highly substitutable for many years. In other countries, however, the impact is more important. The loss of this lever of economic policy by some countries makes cooperative efforts more urgent and places greater responsibility on the G-7 countries (the Group of Seven, which includes the United States, Japan, West Germany, the United Kingdom, France, Italy, and Canada).

There is a third area in which globalization may have an impact on the overall economy and on the conduct of macroeconomic policy, although that impact is not yet well understood. That area is the growing influence of financial markets and financial institutions on resource allocation – that is, on decisions about who gets what slice of the resource pie. The concern about resource allocation reflects the possibility that the sheer size and power of financial institutions give them relatively greater influence in economic and political decision-making than has been the case in the past. That concern is compounded by the declining transparency of the financial system, which makes it much more difficult to assess the extent of that influence. The decline in transparency has also made it more difficult to grasp the factors behind the interventions of central banks in financial markets, as well as the impact of those interventions.

Innovation

Over the past 10 years, a whole range of new instruments, most of them developed in the United States, have come into international use. They owe their existence to their usefulness in the new environment: they open up new sources of funds; they offer better ways to handle risk; and they give added versatility to borrowers, investors, and institutions.

Three Categories

For analytical purposes, the new instruments can be grouped into three broad categories, according to the main

function that they perform (although in reality some instruments have several functions):

- market-broadening instruments;
- risk-management instruments; and
- swaps.

Market-Broadening Instruments

Market-broadening instruments – so called because they increase the liquidity and breadth of markets by opening up opportunities for new borrowers and by attracting new investors (such as pension funds and life insurance companies) to specific markets – include note-issuance facilities, Euro-commercial paper, floating-rate notes, and asset-backed securities.

Introduced in 1981, note-issuance facilities (NIFs) were popular in the mid-1980s, because they met the needs of both lenders and borrowers. They offered a way for banks whose credit rating had fallen to maintain valuable relationships with large corporations. For their part, the issuing corporations did not have to worry about their issues failing – an eventuality that would have left them without the funds they needed.

By 1985, the total volume of NIFs had reached US$34 billion, or 12 per cent of total funds raised on international markets (Table 1). Since then, however, conditions have changed. Regulations have been tightened to require the banks to hold capital reserves against such commitments. As a result, NIFs have declined in importance, and they are now only a marginal means of raising funds.

To a large extent, note-issuance facilities have been replaced by Euro-commercial paper. In 1988, issues of Euro-commercial paper (ECP) – an offshoot of commercial paper developed in the United States – amounted to US$57 billion, or more than four times the amount of NIF borrowings.

As for floating-rate notes (FRNs), their growth was in response to the rise and greater volatility of interest rates in the 1970s. FRN issues peaked at US$59 billion in 1985. The market for perpetual FRNs – mainly issued by banks and corporations, without a set redemption date – collapsed at the end of 1986, for lack of buyers and of financial intermediaries willing to deal out of their own portfolio to maintain a market. The market for dated FRNs – with a maturity of five to seven years – felt the aftershocks deeply; as a result, FRN issues have declined significantly.

Another important innovation has been the growing use of asset-backed securities, created by the packaging of loans into pools of securities. Aided by the U.S. government, the

Table 1

Major Market-Broadening Instruments Issued on International Markets, 1982-88

	1982	1983	1984	1985	1986	1987	1988
				(Billions of U.S. dollars)			
Amounts							
Note-issuance facilities	2.7	3.5	17.4	34.4	24.8	29.0	13.2
Euro-commercial paper	–	–	–	12.6	59.0	55.8	57.3
Floating-rate notes	15.3	19.5	38.2	58.7	54.2	13.0	21.9
Total	18.0	23.0	55.6	105.7	138.0	97.8	92.4
				(Per cent)			
As a proportion of all funds raised on international markets							
Note-issuance facilities	1.5	2.3	8.8	12.3	6.4	7.4	2.9
Euro-commercial paper	–	–	–	4.5	15.3	14.3	12.7
Floating-rate notes	8.5	12.7	19.3	20.9	14.1	3.3	4.9
Total	10.0	15.0	28.1	37.7	35.8	25.0	20.5

SOURCE Organisation for Economic Co-operation and Development, *Financial Market Trends*, various issues.

first mortgage-backed securities appeared in 1970. Their usage has since grown rapidly, and in 1987, 30 per cent of outstanding residential mortgages in the United States were packaged in such pools (see box).

Other asset-backed securities include pools made up of automobile, credit-card, and business loans. Since 1985, small-business loans guaranteed by the Small Business Administration (SBA) – an agency of the U.S. government – have been packaged into pools. The volume of these pooled loans rose from US$84 million in 1985 to US$637 million in 1987. At the end of 1987, half of all SBA-guaranteed small-business loans outstanding had found their way into a pool.

The pooling – or "securitization" – of loans benefits financial institutions, investors, and borrowers, as well as the economy as a whole. By moving some of their loans off their balance sheets and into securities pools, financial institutions can free up capital for increased lending, thus making better use of their capital base. Securitization enables them to specialize in areas where they have a comparative advantage, such as the origination or monitoring of loans, the carrying of loans on their balance sheets, or the packaging of loans and the sale of certificates in the pools. It also facilitates portfolio diversification and the management of risk. Securitization boosts the competitiveness of certain institutions and facilitates the expansion of their business. The securitization of mortgage loans in Canada has enabled smaller regional trust companies to become active in the origination and monitoring of loans without having to hold them on their books.

For investors, securitization widens the choice of investments. It provides them with a more liquid asset than the original loan. As a secondary market in asset-backed securities develops, investors can trade outstanding shares in the pool and thus more readily adjust their portfolios to changing economic and financial circumstances.

For borrowers, securitization increases the availability of funds and lowers their cost. The evidence available – still sparse because of the newness of these instruments – shows that in the United States, SBA borrowers whose debt has been securitized have benefited, in certain regions, from lower costs and longer repayment terms, compared with other SBA borrowers. These gains are associated with the benefits that come from the increased liquidity of the instrument – benefits that have been passed on to the borrowers – rather than with any government guarantee. Similarly, in Canada, the recent revival of the longer-term mortgage can be attributed in part to the securitization of mortgage loans.

For the economy as a whole, securitization improves the efficiency of financial markets and increases the availability of funds outside the large urban areas – particularly in communities served by local or regional institutions. The securitization of mortgage loans in the United States has contributed to the development of an integrated national

Mortgage-Backed Securities

Three basic types of mortgage-backed securities have been issued in the marketplace: mortgage pass-throughs; collateralized mortgage obligations; and mortgage-backed bonds. They differ essentially in the timing and method of repayment of interest and principal to the holders.

Mortgage pass-throughs pool residential mortgages into a fund, and participation certificates in the fund are then sold to investors. As interest and redemption payments are received by the pool from homeowners through the mortgage company, they are redistributed monthly to the certificate holders at the prorata of their share in the pool. Because the investor holds a direct participation in the pool, however, he is subject to the risk of early repayment of the mortgage and, consequently, to an uncertain income stream.

Collateralized mortgage obligations inject more certainty into the income flow by creating four classes of bonds collateralized by the same mortgages, each class being subject to different maturities. The cash flow generated from the pool is first used to pay the interest to the first three classes (A, B, and C) and then to repay the principal of the A class until it is retired, and so on until each class is exhausted. The fourth class (Z) does not receive any payment, even if interest is accrued. When all previous classes of bonds have been redeemed, the Z-class holders receive the accrued interest and then the principal.

Mortgage-backed bonds, issued by the mortgage company, are bonds in which the mortgages act as collateral. The mortgage portfolio remains with the mortgage company, and the payment of interest and principal is separated from the cash flow generated by the mortgages in the pool.

market for mortgages and to a narrowing of regional differences in the availability of mortgage funds.

Risk-Management Instruments

The origin of these instruments – which include financial forwards, futures, and option contracts – can be traced back to the mid-19th century, when commodity options and futures were developed in Chicago to protect merchants against fluctuations in the prices of grain and other crops. Currency futures first appeared in 1972 – one year after the abandonment of the Bretton Woods system signalled the start of an era of increased volatility in exchange rates. Currency options were first used in the Netherlands in 1978; they then spread to the United States and to other countries in the 1980s. Interest-rate futures surfaced in 1975. The growth of all of these instruments has been very rapid, although a retrenchment occurred after the October 1987 stock market crash (Chart 4).

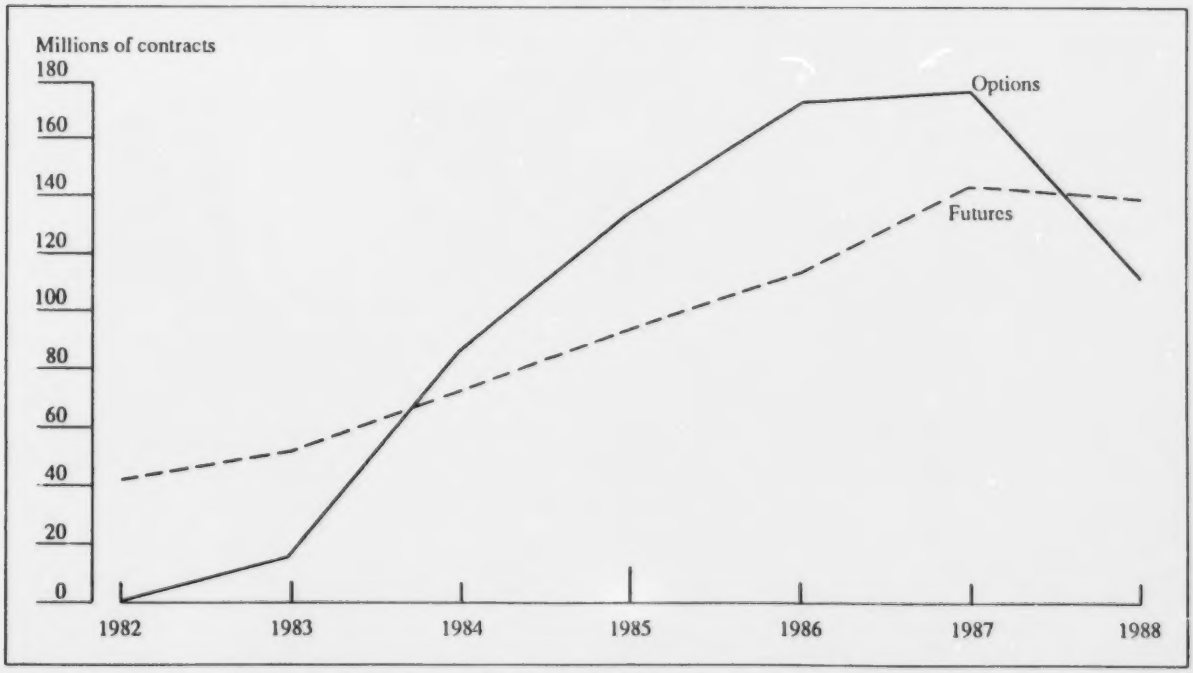
Financial forwards, futures, and options offer institutions, borrowers, and investors opportunities to manage risks (see box). Some seek protection, and in that sense, are hedgers; others try to profit from an uncertain variation in prices and act as speculators. In each case, these instruments enable market participants to assume the degree of risk that they are able and willing to carry.

Swaps

Swaps are arbitraging instruments – that is, instruments that enable market participants to take advantage of price differences between markets in order to make a profit or to lower their costs (see box). Swaps lower the cost of funds for borrowers by breaking the link between the form and location of borrowing from the form in which funds are needed. A borrower who requires Canadian dollars and wants fixed-term interest payments is no longer limited to borrowing Canadian dollars with a fixed term. He may borrow yen at a floating rate and then swap back into a Canadian dollar fixed-rate liability, if the total cost – including the fees associated with the various swaps – is less than that of contracting a fixed-term loan in Canadian dollars. Thus swaps open the way to new markets for a whole range of borrowers by enabling them, first, to tap into the least costly source of funds; and, second, to obtain those funds in the currency and at the interest rates that best suit their needs.

Chart 4

Financial Futures and Option Contracts Traded on U.S. Exchanges, 1982-88



SOURCE Data from Futures Industry Association, *Volume of Futures Trading*; Chicago Board of Exchange, *Annual Market Statistics*; and from the Philadelphia Stock Exchange.

Forward, Futures, and Option Contracts

A *forward contract* is an agreement between two parties to exchange, at a predetermined price, a specified amount and type of commodity or financial instrument at some future date. Forward foreign-exchange contracts are binding contracts to purchase or sell a foreign currency at an exchange rate determined on the day the contract is made, with delivery to occur at a specified date in the future. The agreed-upon exchange rate is based on the differential between the interest rates prevailing for the two currencies that are being exchanged and the contract's term to maturity; it includes the fee of the financial institution, as there is no upfront payment of a premium. It is an over-the-counter transaction between a financial institution – usually a bank or a securities firm – and its customer. The amount and the maturity date of the contract are tailored to the specific needs of the customer. Simple forward contracts do not enable customers to benefit from favourable price movements or to unwind a contract before maturity.

Forward contracts may also involve the delivery of a bond or a bill at a predetermined price; they then offer protection from the risk associated with movements in interest rates. A popular variant is the "forward rate agreement," whereby both parties – usually a bank and its customer – set an interest rate for a predetermined date in the future on a notional (hypothetical) amount of capital. Should the rate be higher on the maturity date, the bank will pay the customer the difference, multiplied by the notional amount; should the actual rate be lower, the customer will pay the bank. Forward contracts and forward rate agreements are rigid types of contracts, because delivery is required at the predetermined date and because there is no mechanism to unwind or reverse the contract before maturity.

A *futures contract* confers the right and the obligation to buy a specific commodity at a fixed date and at a predetermined price. Futures are standardized instruments: they mature on standardized delivery dates, and they are denominated in standardized amounts. The price of the futures contract is derived from the price of the underlying commodity, to which a carrying cost is tagged on. Although some contracts are traded over the counter, the most successful ones are found on organized exchanges.

Currency futures are contracts to deliver a foreign currency, such as the Japanese yen or the British pound; stock-index futures are contracts based on the delivery of a basket of stocks such as the Standard & Poor Composite 500 and the New York Stock Exchange Composite. Interest-rate financial futures are based on a long-term bond, a short-term bill, a certificate of deposit, or a mortgage pass-through. Many of these contracts are based on a cash settlement and not on the physical delivery of the underlying asset. Often, the underlying asset does not have a physical or legal existence, as in the case of stock indices. Moreover, the holders of futures contracts seldom hold their commitments until the expiration date. The contracts are often sold, or the holder unwinds its commitment, by entering into an opposite contract. Parties to the contract only put down a small "good faith margin" – since, technically, the contract only needs to be settled on its expiration date – and every business day, there is payment of the "variation margin," whereby the seller (writer) of the contract compensates the buyer by the amount it has appreciated – or vice versa if the price of the contract has declined.

An *option* is a contract that gives the holder the right, but not the obligation, to buy or sell an underlying commodity or asset. A "call option" is a contract that gives the holder (the buyer of the option) the right, but not the obligation, to buy an asset at a specified price (the exercise or strike price) on or before the expiration date (the "American option") or only on that date (the "European option"). A "put option" is a contract that gives the holder the right, but not the obligation, to sell an asset at a specified price. The buyer of the option pays the seller (or writer) of the option a premium for the purchase of the right. If, before the expiration date, the actual price of the asset increases to a level higher than the price specified in the option, the call holder may exercise his right to buy the asset at the specified price, which is now below the market price. If the market price does not increase beyond the exercise price, then the call holder will not exercise his option and his loss will be limited to the premium paid. A call (or put) option gives its holder a maximum (or minimum) guaranteed price at which he can purchase (or sell) an asset, and thus it is a protection against a rise (or a fall) in prices. Options are traded either on exchanges or over the counter. Option contracts cover specific stocks, stock-index futures, currencies futures, and interest-rate futures. Interest-rate options fix an interest rate on a notional amount. In other words, the seller of an interest-rate call option will commit himself hypothetically to lend to the buyer a specified notional amount of money at a specified interest rate, before the expiration date of the option and at the request of the option holder.

By breaking the relationship between the form and location of borrowing from the form in which funds are needed, swaps have revolutionized the world of finance. Indeed, their role cannot be duplicated by other instruments. For example, a borrower requiring Canadian dollars could borrow yen and then, through the use of options or futures, hedge the exchange risk. However, this type of hedging would only be for a shorter period than that allowed by a swap. But more importantly, the use of options or futures simply transfers the position risk to someone else who must be paid to carry it. In a swap, since each party ends up with the interest-rate structure and currency liability that it was seeking, the need to pay someone to carry risks disappears. Thus everybody gains in a swap. As a consequence, the

Swaps

Swapping is widely used. Young boys and girls in North America commonly swap cards depicting their favorite hockey or baseball players. When they seek a particular card, they do not check every box of cereal in which the cards are found but buy only the first box they find and then swap the card inside with someone who has the card they want.

Interest-rate and currency swaps operate in similar fashion. A borrower or lender who wants an asset or liability with a particular interest-rate structure (fixed or floating, for example) and in a particular currency makes the best deal possible and then swaps the stream of payments with another borrower or lender. For example, a corporation that has obtained a fixed-term loan may assume the interest payment on a floating-rate loan secured by another firm while the latter takes responsibility for the payments on the fixed-term loan. Just as the young hockey or baseball fan might have to make several swaps to get the wanted star, so too might the investor or borrower have to make a series of swaps to get all the desired currency and interest-rate features. That is where financial institutions come in, making the arrangements for a deal between two parties or acting as principal themselves.

Opportunities for swaps arise when one category of borrower or investor has better access than another to a given currency or interest rate. Most currency swaps occur in the context of foreign borrowing, when a borrower can get a better deal in a foreign currency than in its domestic currency. By swapping back into its own currency, the borrower avoids exchange-rate risk. In an interest-rate swap, the parties exchange, so to speak, the interest-rate terms – usually a fixed rate for a floating rate.

development of swaps is almost as important as the development of financial intermediation itself, which broke the tight link between savings and investment.

The small amount of data available tends to confirm the importance of swaps. It has been estimated that in 1986, 80 per cent of yen-denominated bond issues, 95 per cent of Australian-dollar issues, and 90 per cent of New Zealand-dollar issues were swapped. The interest-rate and currency swap markets, which were nonexistent in 1980, are estimated to have been above $889 billion and $219 billion, respectively, at the end of 1987. The swap commitments of U.S. banks increased more than fourfold between December 1985 and September 1987.

Risks

While the new instruments and practices bring many benefits, they also bring new risks. These risks must be managed by financial institutions and understood by regulators. The proliferation of new instruments requires a constant updating of skills in order to understand the dangers, but some institutions simply do not revise their management control systems quickly enough to do this. For example, many over-the-counter transactions on futures and options involve only the taking of a position, with no movement of either cash or securities. They constitute agreements between two parties to trade – or possibly to trade – at a given price and a given date. Generally, these agreements are reached over the telephone, and the obligations of the traders often last only a few hours. The positions are subsequently unwound through a reverse operation or through a matching obligation from another company. Even if a trader keeps an unprotected position for a few minutes only, that is a long enough time for prices to change adversely and for the trader to lose money. Moreover, there is no third-party guarantee that the traders will meet their obligations. Some of the newer instruments, such as options and futures, also encourage financial institutions to take on added risks in the hope of increased profits.

These risks are exacerbated by a decline in transparency. Transactions carried out with traditional instruments and within national borders take place within the view of domestic regulators who are familiar with these instruments. For the most part, what happens appears on the books, the books can be read, and the transaction can be tracked and accounted for. Increasingly, however, that transparency is being eroded, primarily because of the nature of the new instruments. Under conventional accounting approaches, futures and options contracts are not reported on the balance sheets of financial institutions because they are commitments or guarantees, rather than assets or liabilities in the same sense as bonds or stocks. Only in the event that specific conditions in the contract occur – for example, the failure of a counterparty (the party on the other side of the transaction) or the inability of an issuing corporation to sell its debt – will the financial institution be called upon to make payment or to extend credit. Information about the nature and volume of many transactions, and about the parties involved, often is not available. As a result, the system operates, to a large extent, in unmonitored and unsupervised conditions.

The price of that loss of transparency is a diminished ability of regulators and market participants to assess the overall risks being undertaken by financial institutions. Yet, in a globalized world with interconnected markets, that capability is needed more than ever – both to exploit the opportunities and to keep the risks within reasonable bounds.

* * * * *

In brief, the inherent properties associated with the rapid and large-scale internationalization and innovation of the last decade offer the potential of large efficiency gains. These possibilities exist at the macroeconomic (or global) level, where freer markets can be expected to increase the efficiency of resource allocation; they also prevail at the microeconomic (or firm) level, where a wider range of products and aggressive international competition offer certain categories of users the possibility not only of attractive prices but also of products and services that match their specific needs. When the users of financial services are themselves producers of goods and services, this may contribute to lowering their costs of production. For institutions that produce financial services, the growing freedom to do business on a global scale also offers major new opportunities.

Yet in order to achieve these results, it is essential that market participants and regulatory authorities face up to the dangers that flow from these systemic changes in the global financial environment. The Council has identified three principal areas of concern that must be effectively managed. The first is the decline in the transparency of transactions, which has added to the challenge of all those concerned with the system's stability – those who manage the institutions as well as those with responsibilities for prudential supervision. The second is the increased exposure to financial accidents at the institutional level, associated partly, perhaps, with declining transparency but equally, or more so, with the added risk-taking that the changes have encouraged. A third and more general pitfall is the increased risk of a contagion effect associated with growing international and intra-industry linkages.

The Need for International Cooperation

If the many potential large-scale advantages of globalization and innovation are to be achieved, and if the risks outlined above are to be effectively managed, cooperation among nations is needed to ensure that the new international setting will be both stable and competitive. Such cooperation is required at two levels:

- in the harmonization of regulation; and
- in the prudential supervision of financial institutions.

Harmonization of Regulation

Current differences between national governments in the regulation of financial institutions act as barriers to the efficient operation of markets. Not only do they impede fair competition, but they also stand in the way of ensuring the adoption of appropriate solvency standards, which are essential for systemic stability.

A wider measure of commonality in the regulatory framework of nations could reduce these perverse impacts. It would ensure that indigenous firms do not benefit from a special competitive advantage in domestic markets relative to foreign competitors and that solvency standards in one country do not fall below some negotiated international minimum norm. In the absence of a minimal level of harmonization, the institutions based in the countries with loose standards of prudential regulation and with wide investment powers will have an advantage over their more tightly regulated foreign competitors. The risk is that this kind of situation could lead to a general relaxation of regulatory standards, as national governments compete with one another to offset the competitive advantages enjoyed by the institutions based in the country with the lowest standards. To avoid this kind of competition, certain characteristics of the regulatory framework need to be very similar from one country to another – such as standards with respect to capital adequacy, solvency and liquidity ratios, asset diversification, and the monitoring of risks. At the same time, other rules – such as those which govern the powers of institutions – may differ among countries without jeopardizing either fair competition or solvency.

Achieving cooperation is no easy task. It requires agreement not only on basic principles but also on practical questions of implementation. Those difficulties are compounded by variations in legal and institutional frameworks and in the economic status and objectives of nations at different levels of development.

Progress has so far been slow and uneven. Some harmonization has been achieved through planned, deliberate cooperation – the European Community's directives aiming at a single market by the end of 1992, for example. In other cases, the internationalization of markets has spurred unilateral action. Some nations have changed their rules because they did not want to impede the competitive efforts of their institutions.

Prudential Supervision

In the absence of harmonization of regulation, international cooperation among supervisors of financial institutions could still reduce the risks of a financial accident. Cooperation is most advanced in the supervision and regulation of commercial banks, thanks to the efforts of the Bank for International Settlements (BIS). The major landmark of this progress is the Basle Concordat (adopted in 1975), which deals with prudential supervision – the supervision of institutions with a view to maintaining their solvency and protecting their customers. The concordat is based on two main principles: no institution should escape supervision; and supervision should be adequate wherever institutions operate. Under this agreement, responsibility is shared between the host country and the home country, depending on the form of the establishment (subsidiary, branch, or joint venture) and the area of concern (solvency, liquidity, foreign-exchange position). It also affirms the principle of consolidating, for prudential supervision purposes, the worldwide assets, liabilities, and operating results of financial institutions and their subsidiaries into a single financial statement.

A second major cooperative effort in the banking area was the 1988 agreement by major industrial nations to impose consistent capital requirements on their "international" banks – i.e., banks that operate in world markets. By 1992, the international banks of the parties to the agreement will have to maintain a risk-weighted capital/asset ratio of 8 per cent, of which a minimum of 4 percentage points must be composed of common shares and disclosed reserves. Different risk weights were established for different categories of assets – zero for central-government bonds, 50 per cent for residential mortgages, 100 per cent for commercial loans, and so on. The weights are determined in relation to credit risk – i.e., the risk that a counterparty may fail.

Work is now proceeding within the BIS on how to treat another major risk faced by banks with international operations – position risk, which can arise when an institution borrows short-term funds to fund long-term commitments or when its assets in a particular currency are smaller than its liabilities in that currency.

Despite the dramatic growth of securitization in recent years, progress in the supervision of securities firms has been much slower than in the supervision of banking. The International Organization of Securities Commissions (IOSCO) was established in 1973 to foster cooperation among securities regulators in North and South America. Although this body has since expanded to include the regulators of 45 nations, it is still in its infancy and has yet to forge any agreement on critical issues – hardly surprising, when one considers that it took more than a decade to negotiate the Basle Concordat. For the most part, coordination in the securities area so far has involved bilateral agreements; an example is the memorandum of understanding between the Toronto Stock Exchange and the U.K. Securities and Investment Board on the sharing of information and on mutual recognition of supervision.

Unless regulators can forge agreements on a number of major issues – such as the transfer of information; the control of fraud, self-dealing, and abuses of conflict-of-interest situations; and capital-adequacy standards – the world's financial system will be vulnerable to accidents in the securities area, and borrowers and lenders may face greater risk in international dealings.

Are the New Trends Reversible?

Should the internationalization of markets continue unabated and should the use of new instruments continue to increase, the need for regulatory cooperation and for domestic adaptation would become even more urgent. Thus it is important to determine whether these trends will endure. Could a worldwide economic setback, for example, roll back the forces of internationalization and financial innovation? After the 1929 collapse of the stock market and the deep economic crisis that followed it, the resulting interruption in cross-border capital flows lasted for decades. No one can guarantee that this could not happen again, although the circumstances that prolonged that freeze – including the Second World War – were certainly extraordinary. Today, a more likely solution to such a crisis would be a joint international effort. In fact, an important objective of recent international cooperation has been to put in place mechanisms to respond to crises of this type. Thus it is doubtful that the globalization of financial markets will be reversed, even in the event of a serious crisis.

Besides, recent experience clearly demonstrates the resilience of the underlying trends. The level of activity in international markets sagged in the aftermath of the October 1987 stock market crash, but it soon rebounded. While there was a retrenchment by some institutions at the time, many others held fast in their commitment to the international market. Less than a year after the crash, Japan launched its stock-futures market.

The compelling logic of economic efficiency provides the main explanation for this resilience. Internationalization and innovation have resulted in increased competition, greater specialization, and new services. They have given

institutions new opportunities to compete in wider markets and an added capacity to specialize in particular activities. Borrowers have gained easier access to competitive markets and an enhanced capacity to obtain financing that meets their specific requirements. The new trends also offer the potential for better risk management and for an overall improvement in the worldwide allocation of resources. Globalization and innovation have been facilitated by new technologies and supportive government policies, and we cannot foresee any forces that could reverse the economic or technological factors that propelled these developments.

Predicting the behaviour of governments is more difficult. If governments were to re-impose barriers or to ban the use of specific instruments, they would undoubtedly meet resistance from borrowers, investors, and financial institutions, who would not willingly give up the benefits procured by the recent changes and who, in all likelihood, would seek to avoid any restrictions; with the use of modern technology, that would probably not be too difficult.

When countries have imposed limits on the use of various instruments in the past, the chief effect has been to drive many transactions outside their borders. For example, restrictions on the use of certain types of instruments by the West German authorities resulted in the Deutsche Bank – the country's largest bank – locating its capital-market division in London rather than in Frankfurt.

Another factor making it unlikely that the recent trends could be reversed is that there remains much scope for further development. Important segments of the market – of the retail market, in particular – have so far been little affected by globalization and financial innovation. Under the appropriate conditions, there might well be scope for the debt issues of some medium-sized corporations to be brought to international markets. There is also room for foreign firms to challenge domestic firms in many segments of national markets. In addition, smaller firms and investors might find it economic to use certain innovative instruments and techniques. The pooling of various kinds of loans has just begun, and securities pools made up of the assets of retail borrowers could be brought to international markets.

Although the globalization of markets and financial innovation are likely to continue, the pace of progress could well slow down over the next few years, for at least two reasons: the restructuring that is currently taking place in the financial industry; and the remaining barriers to internationalization.

After the initial rush by financial institutions to position themselves on international and domestic markets as they were opening up, a normal restructuring is now taking place, with many firms withdrawing from those segments of the market which are unprofitable for them and concentrating their efforts and resources in areas where they are enjoying more success.

In addition, there remain important institutional barriers to the globalization of markets for many kinds of securities. For example, while it was relatively easy to internationalize the market for U.S. or U.K. government bonds, it will be much more difficult to achieve the same goal in the markets for corporate bonds and equities. It is relatively easy to "transport" the liquidity of government bonds – that is, the ability to trade them without directly affecting their price – from one market to another, because information on those securities is readily available worldwide. In the case of corporate securities, however, liquidity is less easy to transfer abroad because foreign investors are less familiar with the issuing corporations and thus are more reluctant to add their securities to their portfolio, and because fewer financial institutions abroad are prepared to maintain a market for such issues.

Other obstacles to internationalization are found in the differences that exist between countries with respect to prospectus requirements, accounting procedures, and clearing and settlement mechanisms. Finally, in some countries, there remain barriers to cross-border capital flows or to the establishment of foreign institutions in domestic markets.

Despite the remaining barriers, the Council is convinced that the world of finance has been fundamentally transformed by the forces of internationalization and innovation – and that there is no looking back.

3 Canada at the New Frontier

Canadian institutions have operated in international financial markets for many years. The first foreign branches of Canadian banks to be set up abroad were established before Confederation: the Bank of Montreal opened for business in New York in 1859, in Chicago two years later, and in London nine years after that. Later, the Canadian Bank of Commerce established offices in the United States, the United Kingdom, and Mexico.

Historically, too, Canadians have been important investors and borrowers abroad. Their economy has been heavily financed by non-residents – in the early years, mainly from the United Kingdom; and later, from the United States. The Canadian Pacific Railroad and other nation-building projects were funded with foreign money. Except in time of war,

capital has flowed across Canada's borders with almost no restriction.

How have Canadian investors, borrowers, and financial institutions adapted to the recent worldwide developments? We answer this question by looking at the participation of Canadians in the processes of internationalization and financial innovation and at their use of foreign institutions; at the loss of market share experienced by Canadian-controlled financial firms; at the penetration of domestic markets by foreign institutions; and at a number of associated domestic issues.

Canadian Participation

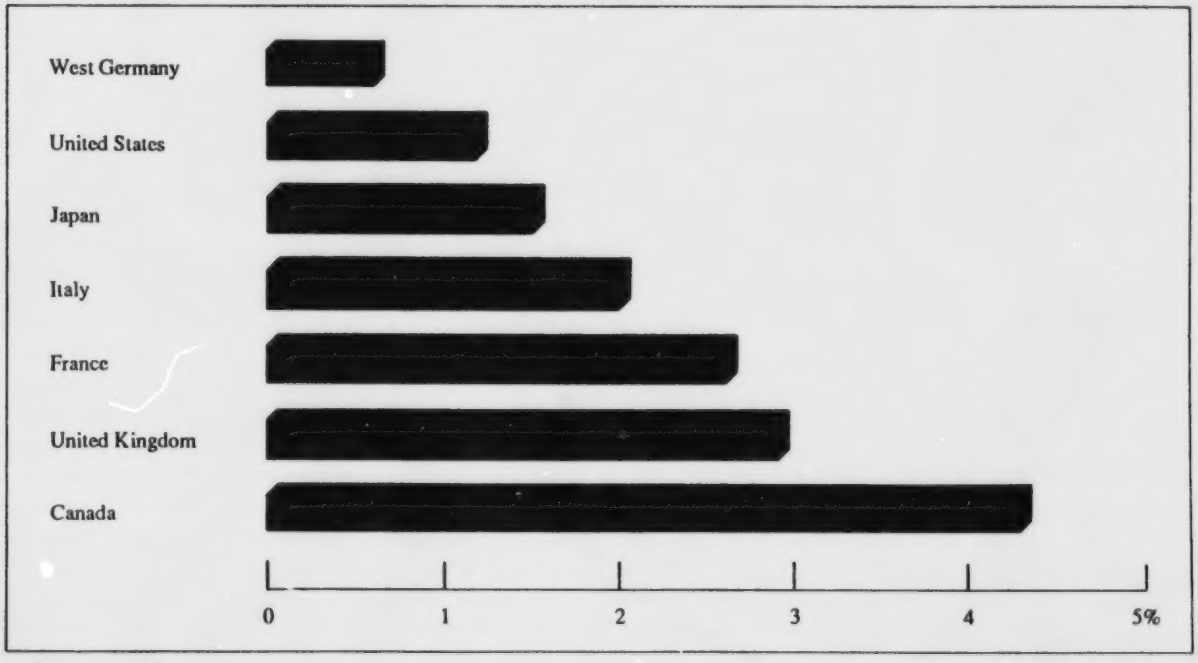
Over the past quarter of a century, the internationalization of Canada's financial markets has quickened, with Canadian borrowers turning increasingly to international markets for funds. The annual sale of Canadian bonds to non-residents, for example, rose from $1.3 billion in 1970 to almost $71 billion in 1988. Today, Canadians borrow larger amounts abroad, relative to the size of their economy, than do the nationals of other major industrialized countries (Chart 5).

The proportion of Canada's total financial requirements funded outside North America has also increased over the past 25 years (Chart 6). One significant feature of that growth is that it has taken place exclusively in the wholesale market – the market for large loans and deposits and for the securities issued by large firms, institutions, and governments. The retail market – for personal and small-business loans, and mortgages – has remained a domestic activity. The rush to foreign markets has been led by the federal crown corporations and by private financial institutions (Chart 7).

Canadians have been venturing abroad for a variety of reasons. One is simple bargain-hunting: in an environment where the best deals migrate from one market to another, it pays to shop around. In a 1988 Economic Council survey of large and medium-sized Canadian corporations, 85 per cent of respondents who had borrowed abroad cited the cost of funds as one of the main reasons for doing so (Chart 8). In that context, the large deficits of the federal government, which have been financed largely through domestic borrowing, may have forced many other borrowers to seek funds on foreign markets.

Chart 5

Funds Raised on International Markets, as a Proportion of GDP,[1] Selected Countries, 1982-87

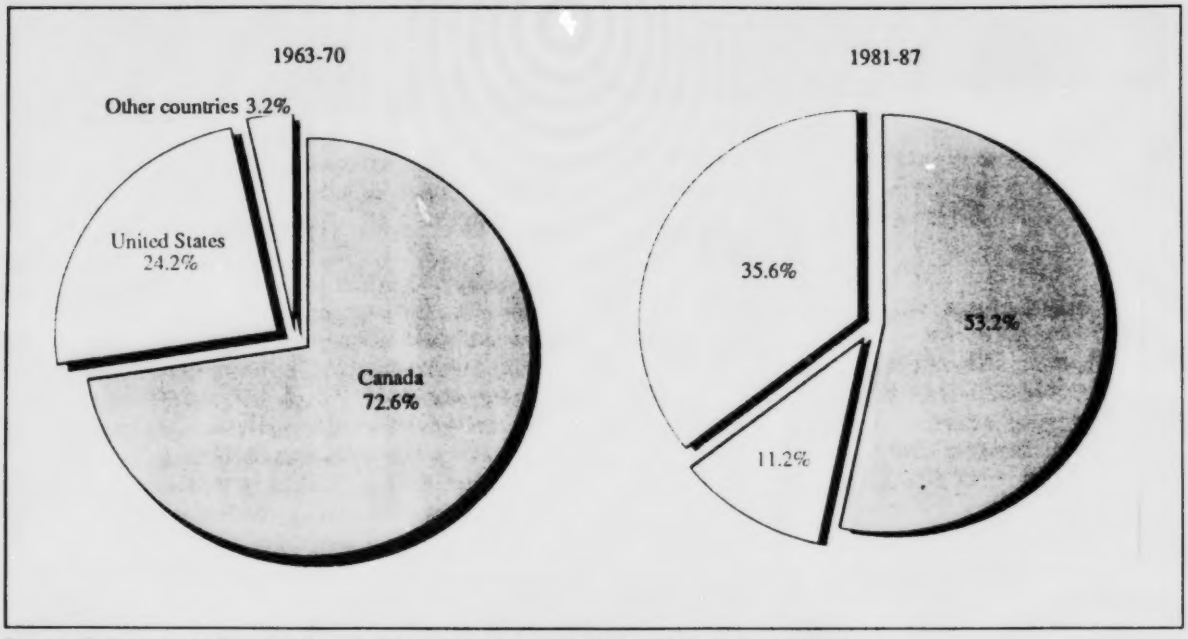


1 Based on annual averages.

SOURCE Estimates by the Economic Council of Canada, based on OECD, *Financial Statistics Monthly*, Part 1, and *National Accounts of OECD Countries*, various issues.

Chart 6

Placement of Canadian Bonds, 1963-70 and 1981-87



SOURCE Estimates by the Economic Council of Canada, based on unpublished data from the Bank of Canada.

Innovation in the financial area has also had an impact on Canadians. They have made extensive use of some instruments and less of others. Swaps, which offer borrowers the opportunity to tap a variety of foreign sources of funds and to escape the limited resources of Canadian markets, are widely used. So are forward contracts, which are intended to eliminate some of the foreign-currency exposure of the borrower or the investor. In our survey, no fewer than 57 per cent of respondents had, at one time or another, entered into a forward contract.

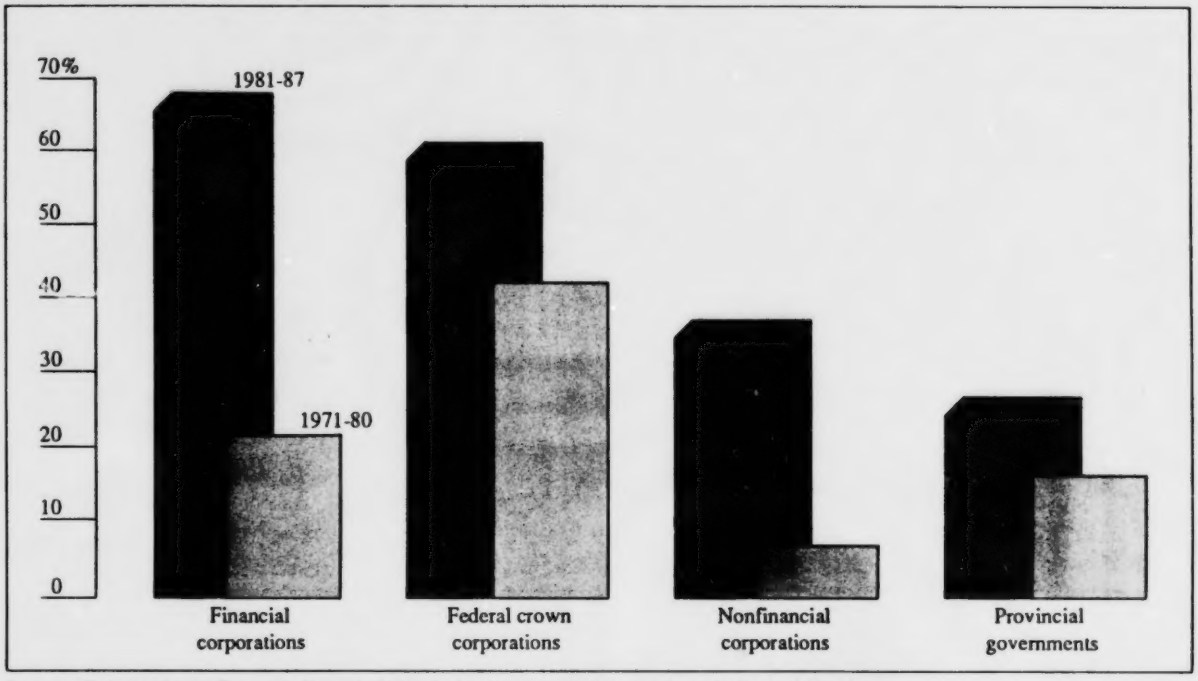
On the other hand, the use of Euro-commercial paper by Canadians has been much more sparse. While Canadian borrowers accounted for 4.1 per cent of all short- and medium-term issues on international markets in the period 1983-88, the corresponding figure for Euro-commercial paper issues was only 2.6 per cent. Their lower participation in that market may be attributable to the existence of a well-developed domestic commercial-paper market. Our survey also revealed that a large majority of respondents had never used some of the other new financial instruments: 95 per cent, in the case of interest-rate futures or options; 85 per cent, in the case of currency options; and 91 per cent, in the case of forward rate agreements. Respondents viewed these instruments as too speculative, too costly, or not suited to their needs; some were simply unaware of them.

Attempts to develop a market for financial futures in Toronto and Montreal have so far not been very successful. For such markets to function effectively, a minimum volume of business is required, but the relatively small size of the Canadian economy generally acts as a barrier to the achievement of that "critical mass." Another obstacle is the small number of players: if only a few institutions and individuals are interested in participating, a market cannot be sustained. The proximity of the Chicago futures and options markets is another disincentive to the development of financial-futures markets in Canada.

Mortgage-backed securities appeared in Canada about 15 years later than in the United States. That is because the specific factors that favoured their development in the United States were not present in this country. Canadian chartered banks were not prevented from opening branches from coast to coast and, as a consequence, did not have the same problem of regional diversification as their U.S. counterparts. In addition, lenders and borrowers in Canada

Chart 7

Proportion of Canadian Bonds Issued Outside Canada and the United States, by Category of Borrower, 1971-80 and 1981-87



SOURCE Estimates by the Economic Council of Canada, based on unpublished data from the Bank of Canada.

adapted to volatile interest rates by shortening the term to maturity of mortgages.

Nevertheless, securitization also took hold in Canada in the mid-1980s because, by enabling institutions to specialize and to make better use of their capital base, it contributed to the greater overall efficiency of the financial system. While the first traditional mortgage-backed securities appeared in November 1985, the market for these instruments remained lethargic until the Canada Mortgage and Housing Corporation (CMHC) became involved in their development in January 1987. About 457 million dollars' worth of mortgage-backed securities were issued in 1987; by the fall of 1988, the total dollar value of such issues since the beginning of the program had passed the $1-billion mark. All of the issues come from private sources – mainly smaller trust companies. The CMHC guarantees the timely payment of both interest and principal, and all mortgages are insured under the National Housing Act. In 1988, securitization was extended to public-housing mortgages; by the end of the year, a total of $215 million had been issued on that market. While the CMHC's program is relatively small in scope, it appears to be successful. The corporation intends to maintain it and will likely extend it to other areas.

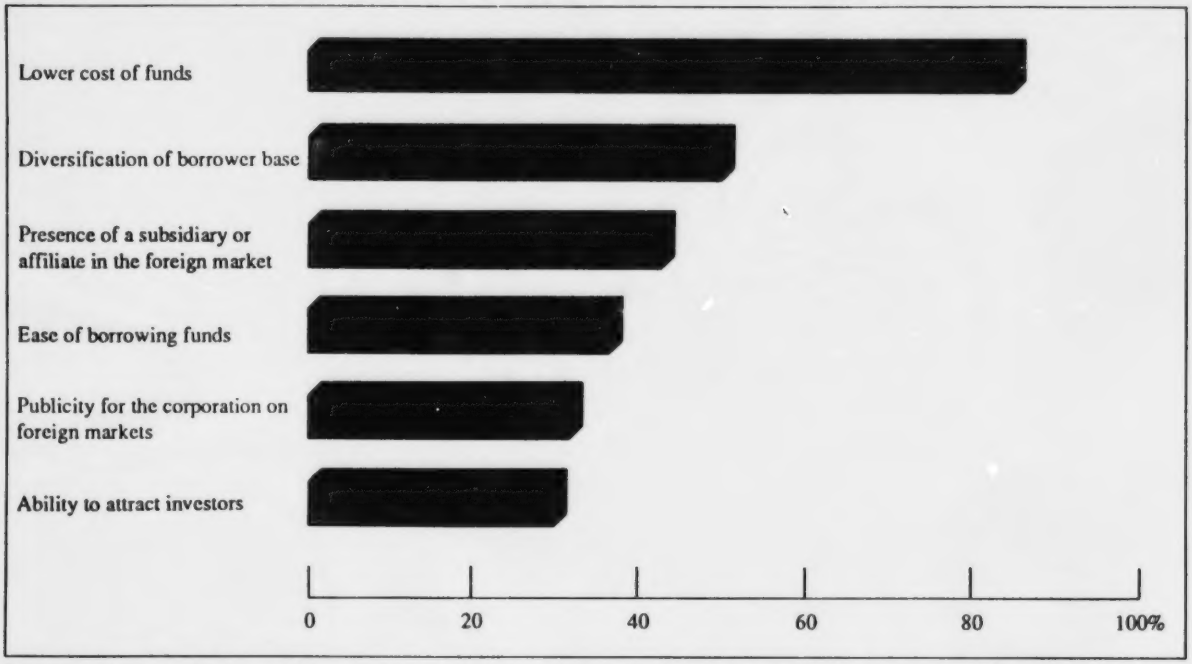
Use of Foreign Institutions

When Canadian corporations go to the international market in search of funds, they often contract non-Canadian institutions to manage the issues. Canada's financial institutions have been much less active than might have been expected in managing issues on behalf of Canadian firms or issues denominated in Canadian dollars.

Thus Canadian institutions handled only 32 per cent of all Eurobond issues denominated in Canadian dollars between 1980 and 1988; during that same period, French institutions, for example, managed 100 per cent of all Euro-franc issues, and West German institutions managed 88 per cent of all Deutschemark issues on the Eurobond market. Of those issues originating from Canadian borrowers, Canadian institutions managed only 44 per cent of the total. This was in sharp contrast with the experience in other countries, where

Chart 8

Reasons Given for Borrowing on Foreign Markets by Nonfinancial Canadian Corporations



SOURCE Estimates by the Economic Council of Canada, based on an ECC survey of nonfinancial businesses about their use of international financial markets and of new financial instruments, 1988.

domestic institutions typically managed 90 per cent of the international issues of their own nationals in their own currency.

Loss of Market Share by Canadian Institutions

Not only do Canadian institutions play a relatively small role internationally, but they have been losing ground in recent years. Several indicators – including market share and the size of assets – can be used to measure this phenomenon.

Globally, the share of Canadian banks and securities firms as managers of issues in the Eurobond market declined from a high of 6 per cent in 1976 to a low of 2 per cent in 1988 (Table 2). In the management of international loan issues, their overall share dropped from 8 per cent in 1983 to 3 per cent in 1988 (Table 3). Their participation in the Canadian-dollar segment of the market remained more or less steady (at around 75 per cent) over the period, but their share of U.S.-dollar issues by Canadian nationals declined. Because Canadians issue only 15 per cent of their international loans in Canadian dollars and almost 73 per cent in U.S. dollars, this resulted in an overall loss of share of Canadian institutions in this market. A similar picture emerges with respect to Eurobond issues, where Canadian institutions have been losing ground in the U.S.-dollar-denominated market.

Canadian banks have experienced a significant weakening of their relative position in terms of assets. For example, Canada's largest bank – the Royal Bank – ranked 16th in the world in 1981 and 57th in 1987. The decline cannot be attributed to the realignment in currencies in recent years – at least not in any notable way. Even when currency movements and differences in national inflation rates are taken into account, the Royal Bank's ranking moves up only slightly – to 53rd place. Displacing it in the rankings over the past eight years were banks from the United States, the United Kingdom, Japan, Switzerland, France, West Germany, Hong Kong, Italy, the Netherlands, Brazil, and China.

In part, this retrenchment reflects the fact that Canadian institutions have been withdrawing from the markets where they were losing money as a result of intensified competition. However, this profit squeeze was also

Table 2

Share of Canadian and U.S. Institutions in Managing Eurobond Issues, 1970-88

	Canadian share of:				
	Canadian-dollar issues[1]	U.S.-dollar issues	U.S.-dollar issues by Canadians[2]	All issues	U.S. share of all issues
			(Per cent)		
1976	36.1	3.7	13.0	6.3	16.1
1977	41.9	5.0	22.0	4.9	10.7
1978	--	0.5	7.8	0.2	10.2
1979	28.2	3.9	30.5	3.4	20.5
1980	18.7	5.0	33.9	3.6	21.0
1981	37.3	3.6	10.9	4.2	26.9
1982	18.2	2.8	15.3	2.7	30.7
1983	44.2	2.2	10.6	3.1	19.1
1984	41.2	1.5	15.8	2.5	35.5
1985	43.3	1.8	19.4	3.0	34.6
1986	48.3	0.8	10.4	2.5	27.5
1987	32.0	0.1	--	1.9	17.1
1988	23.0	0.3	7.8	2.0	19.4
1970-79	32.3	2.8	17.5	3.0	17.1
1980-88	32.4	1.4	13.4	2.5	25.5

1 Eurobond issues denominated in Canadian dollars accounted for 3.8 per cent of all Eurobond issues over the period 1966-88.
2 Eurobond issues denominated in U.S. dollars accounted for 54 per cent of all Eurobond issues by Canadians over the period 1966-88.
SOURCE Estimates by the Economic Council of Canada, based on data from IFR Publishing Ltd.

Table 3

Share of Canadian and U.S. Institutions in Managing International Loans, 1983-88

	Canadian share of:				
	Canadian-dollar loans[1]	U.S.-dollar loans	U.S.-dollar loans issued by Canadians[2]	All international loans	U.S. share of all international loans
			(Per cent)		
1983	72.7	6.8	71.7	7.7	28.2
1984	77.0	4.6	90.9	4.5	51.9
1985	66.1	4.2	13.0	3.6	36.6
1986	71.2	2.3	1.7	2.6	44.7
1987	100.0	3.7	10.4	3.5	45.7
1988	77.5	2.3	7.7	3.0	51.1

1 Canadian-dollar-denominated international loans accounted for only 0.75 per cent of all international loans over the period.
2 U.S.-dollar-denominated loans accounted for 73 per cent of all loans issued by Canadians over the period.
SOURCE Estimates by the Economic Council of Canada, based on data from IFR Publishing Ltd.

experienced by foreign competitors, many of whom nonetheless elected to ride out the storm. Some Japanese institutions, in fact, are entering some markets for the first time, even though they do not expect to see positive returns for some time. And, contrary to the widespread belief that the loss of market share is a phenomenon common to North American institutions, U.S. firms have been gaining ground, as shown in Tables 2 and 3. Indeed, many institutions in the United States (and in a number of other countries) have successfully restructured their operations in order to maintain an important presence in international markets.

The rationalization of operations generally means that institutions focus on markets where they have a comparative advantage because of their knowledge or expertise in a particular area, of a strong physical presence, or of a privileged link with customers. The institutions of many countries are strong in dealings in their own currency and with their own nationals. But as noted above, Canadian institutions have not shown the same relative strength in such markets, and they have even lost some ground in the management of issues by Canadian borrowers.

The loss of share on international markets, coupled with a relatively weak performance in what might have been thought as their "natural" niche, suggests that the problems of Canadian institutions may be more deeply rooted. Other indicators, such as gross earning margins – the difference between interest received and interest paid – and the rate of return on assets, generally point to a below-average performance by Canadian banks when compared with banks in seven other industrial countries (Table 4 and Chart 9). Their operating costs are about in the middle of the range. But asset growth since 1980 has been about half the average for the countries shown in the table.

We were surprised by these findings. The loss of market share by Canadian institutions has received little attention until now, perhaps because it took place in markets that were growing rapidly. We are unable to offer a single explanation for this loss, as several factors seem to have been at work. Interviews conducted by the Council's staff indicated that, in the opinion of many of their Canadian customers who are regular participants in international markets, Canadian banks and securities firms are less aggressive in pricing than their foreign competitors. It was also suggested that Canadian institutions lack the worldwide networks that their foreign rivals have built up over the years, that they do not have the same access to retail investors. There was a general impression that their strategies tend to be focused inward. All this may be attributable, at least in part, to their smaller size and weaker capital base relative to those of their major foreign competitors.

Table 4

Measures of Bank Performance, Selected Countries, 1980-87[1]

	Operating costs[2]	Gross earnings margins[2]	Rate of return on assets[3]
		(Per cent)	
Japan	1.04	1.58	0.47
Switzerland	1.40	2.43	0.64
France[4]	1.84	2.74	0.15
Canada[5]	2.02	3.32	0.47
West Germany	2.61	3.58	0.73
United States	2.87	4.21	0.61
Italy[6]	3.04	4.63	0.75
United Kingdom	3.44	4.98	0.77

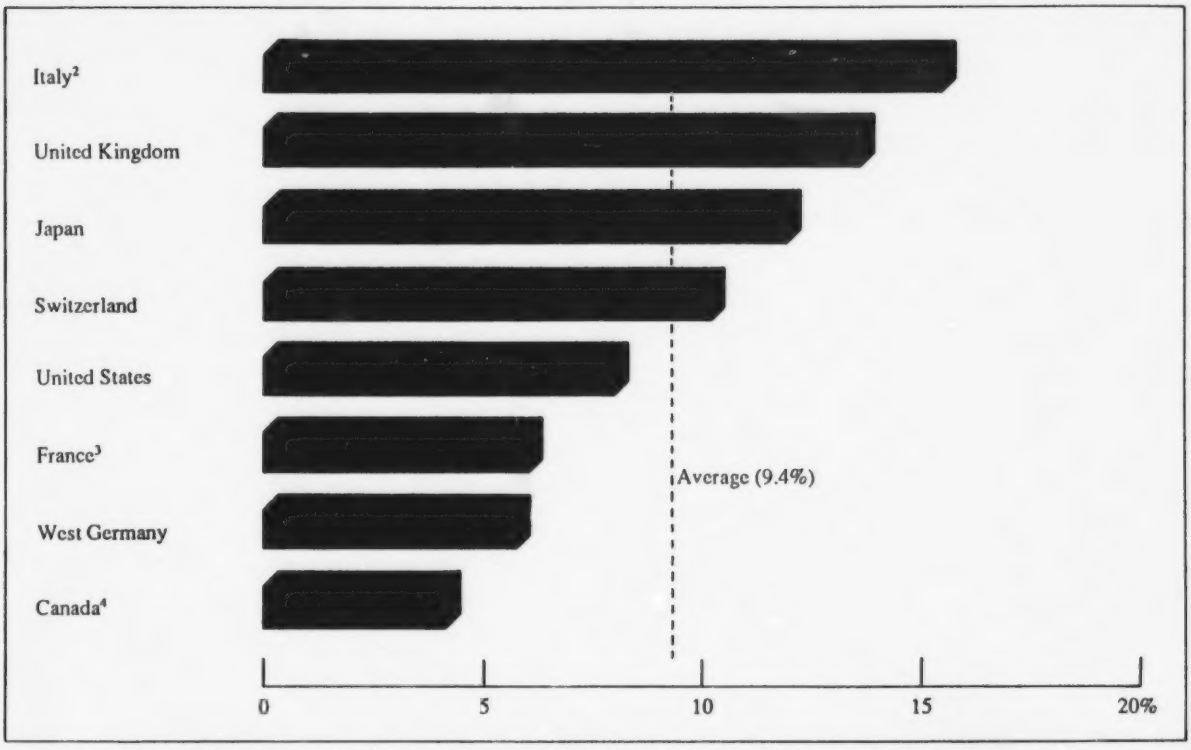
1 The data for Italy cover all banks; for the United Kingdom, all clearing banks; and for Canada, all Schedule A banks. For all the other countries, the data pertain to the major banks.
2 As a proportion of total assets.
3 Based on pre-tax income.
4 1982-86 only.
5 1982-87 only.
6 1980-86 only.
SOURCE Organisation for Economic Co-operation and Development, *Bank Profitability, 1980-1984*, Paris, 1987; reports of various central banks; and other sources.

The observations made by the customers of Canada's financial institutions can perhaps be linked in part to the way the industry has evolved historically and to the regulatory framework that has governed them over the years. For example, until 1987 the chartered banks were prevented by domestic regulation from being active in the corporate-securities business – an area that has experienced strong growth in recent years. At the same time, Canadian securities firms, whose main line of business was underwriting and dealing in such securities, simply did not have the capital base necessary to meet foreign competition. While commercial banks in the United States were facing the same constraints as Canada's chartered banks, U.S. securities firms had the large amounts of capital needed to become major players in international markets. Changes in the Canadian regulatory environment over the past two years have removed the barrier between commercial banking and securities underwriting; it remains to be seen whether this will enable Canada's securities underwriters to stem the loss of market share.

Another factor that may have contributed to Canada's loss of market share is the fact that the pool of domestic savings available to its financial institutions has not grown as quickly as that available to institutions in some other countries. The

Chart 9

Average of Annual Rates of Growth of Nominal Assets of Major Banks,[1] Selected Countries, 1980-87



1 For Italy, the data pertain to all banks; for the United Kingdom, to all clearing banks; and for Canada, to all Schedule A banks.
2 1980-86 only.
3 1982-86 only.
4 1982-87 only.

SOURCE Organisation for Economic Co-operation and Development, *Bank Profitability, 1980-1984* (Paris, 1987); reports of various central banks; and other sources.

figure for Canada, as a percentage of that of the major industrialized nations, declined from 5.4 per cent in 1981 to 3.5 per cent in 1986. Over the same period, that of Japan increased from 29.3 per cent to 33.3 per cent. It should be pointed out, however, that Canada's loss of the world market share has been more pronounced than the decrease in its share of available savings.

Canada's loss of ground on international markets could become a source of concern. If Canadian institutions continue to lose market share and to reduce their international operations, they may eventually find it difficult to retain their traditional Canadian customers in the face of competition from the better-capitalized and more internationalized institutions.

The ultimate consequence of giving up market share now could be an erosion of long-term competitive strength. The institutions that ride out difficult times in a given market can build up significant advantages over those which leave – although, in some cases, withdrawal from a specific market may be an appropriate decision. A large part of international finance is transactions-oriented – that is, the seller who offers the best price gets the deal – and thus an institution can re-enter a market simply by making the best offer. However, re-entry does require financial strength, experience, and knowledge of what is happening. This can be lost when institutions withdraw, making it more difficult to formulate winning offers in the future.

Foreign Penetration of Canadian Markets

The loss of market share by Canadian institutions in international markets is happening just when Canada is re-opening its own domestic markets to foreigners, particularly

in the banking and securities sectors. Prior to 1967, there were almost no restrictions on the entry of foreign banks into Canada or on foreign ownership of Canadian banks. Fears that foreign banks might dominate the Canadian industry prompted changes, however. The Bank Act revisions of 1967 ended this open-entry policy, prohibiting foreign banks from operating as banks in Canada. They could, however, operate affiliates providing leasing, factoring, and some other banking services. Foreign-bank affiliates grew more than twice as fast as Canadian banks between 1974 and 1980, but their share of the market remained relatively small (only 3 per cent of the combined assets of Canadian banks and foreign-bank affiliates in 1980).

Revisions made to the Bank Act in 1980 relaxed those restrictions. Foreign banks were allowed to incorporate subsidiaries under Schedule B of the act, but the legislation maintained limits on the power to establish branches and on the rate of asset growth of these subsidiaries. By December 1988, Schedule B banks (all but one of which were foreign-owned) held 12.3 per cent of total bank assets – a fourfold increase during the 1980s. In particular, foreign-bank subsidiaries were able to make significant inroads into the markets for interbank loans and for term lending to businesses. They also became active participants in the bankers' acceptance market. Still, the limits on their growth effectively guaranteed Canadian-controlled banks the overwhelming share of the domestic market.

The Canada-U.S. Free-Trade Agreement has introduced a new set of legal parameters into the domestic banking situation. The agreement gives U.S. banks almost automatic entry into Canada and removes the limits on their asset growth. Their Canadian subsidiaries are no longer required to obtain the approval of the Canadian authorities before opening branches here, so that in effect, they enjoy the same opportunities as Canadian banks. With those barriers now removed, there is every reason to anticipate that Canadian institutions will, in the future, face a much tougher challenge in their efforts to retain their share of the domestic market.

Foreign ownership of securities firms was not an issue in this country until 1969, when Merrill Lynch, Pierce Fenner and Smith (a U.S. firm) acquired Royal Securities. In reaction to the takeover, the Ontario government introduced new rules limiting foreign ownership of any securities firm to a maximum of 25 per cent. Foreign firms that were already established in Ontario were exempted from this rule, but they were limited to a rate of asset growth equal to the average rate for major Canadian firms. In 1973, however, the Quebec government decided on a very different approach by removing all restrictions on either the entry of foreign securities firms or foreign participation of those already in Quebec.

By 1987, the need for more capital in the securities industry led to the removal of the restrictions on entry into the Ontario securities industry; Canadian banks, insurance companies, and trust companies were the first to benefit from the new policy, which was extended one year later to foreign firms. In 1987, British Columbia fully opened up its doors to foreigners, as the Vancouver Stock Exchange allowed foreign membership.

Theoretically, foreign entry into banking, securities dealing, or any other segment of the financial-services industry should bring benefits above and beyond those which result from a freer flow of capital across borders – through increased competition and through the spread of new ideas and new technology. Indeed, some foreign institutions have introduced and promoted new financial products in Canada. As noted above, foreign banks play an important role in some specific sectors of the banking market: three of the 12 largest financial firms in the Canadian market for business and personal loans are subsidiaries of foreign banks. In the market for corporate loans, foreign institutions have lowered the cost of funds, particularly for firms using bankers' acceptances.

Moreover, some of the foreign entrants are subsidiaries of institutions that are larger than their Canadian counterparts and that are, therefore, better able to withstand shocks of various kinds. In that sense, their presence in Canada may add to the stability of the domestic financial system.

The entry of foreign banks, with their innovative technology and highly developed world networks, also has the potential to improve consumer access to a wide array of financial services. In practice, most of the newcomers have settled in the larger towns and cities rather than in the smaller communities. As a result, these potential benefits have, until now at least, not materialized in those areas where they are, perhaps, most needed. Whether U.S.-controlled institutions will move more strongly into the Canadian market and whether they will provide services to all regions, now that all barriers have been removed, remains to be seen.

The stimulating effects of foreign entry must be balanced against the desirability of maintaining a strong Canadian-controlled financial sector in the home market. Because the quality of the information on which all financial decisions must rely tends to deteriorate with distance, institutions headquartered in Europe, Asia, or the United States are often

less familiar with the needs of Canadians than are domestic institutions. In addition, the corporate objectives of foreign financial institutions may, at times, be more attuned to conditions and policies in their home country than to Canadian circumstances. Financial institutions that are rooted in Canada are also more likely to support the financing of Canadian exports than would an institution with its home base elsewhere. Finally, domestic ownership of the nation's major financial institutions may also have a symbolic value in the eyes of Canadians who deal with them on a day-to-day basis, borrowing money, buying and selling assets, and leaving their life savings in the care of those institutions.

There is no obvious way of measuring the direct and indirect benefits and costs of a laissez-faire policy that would let foreign-controlled firms dominate the Canadian financial-services industry. Given the declining share of the growing international markets held by Canadian institutions and given the fact that foreign entry could make matters more difficult for Canadian banks and securities firms in their domestic markets, one cannot preclude the possibility of an erosion of their share in those markets. We suggest, therefore, that policy makers begin, at least, to monitor market trends more closely. But it will be the operating decisions of the managers of Canadian banks and securities firms that must ultimately determine whether Canadian-controlled institutions will retain their dominant position in the domestic market. It is they who will have the strongest influence on future events. Government efforts should be aimed at strengthening the competitiveness of Canadian institutions, not at finding new ways to protect them.

The Resurfacing of Long-Standing Issues

Against the backdrop of globalization and financial innovation, several domestic issues that have long been of concern to Canadian policy makers take on added importance. They include:

- the restructuring of the financial system;
- commercial/financial links;
- the regional availability of financial services;
- the solvency of financial institutions;
- the fragmentation of financial regulation; and
- the need for better cooperation among domestic regulators.

Restructuring of the Financial Sector

In response to recent regulatory changes allowing the cross-ownership of financial institutions and to strong market pressures to diversify, many Canadian institutions have merged or forged alliances with – or purchased outright – other firms in the industry. Today, for example, every major Canadian bank owns a securities firm or has a securities affiliate. One securities firm has applied to establish a bank; another plans to form a trust company.

Such restructuring is not unique to Canada; it has taken place in many other countries, as companies in the financial-services business have tried to strengthen their presence in their domestic market, in order to compete more effectively against foreign rivals. In Canada, restructuring raises concern with respect to its impact on the degree of concentration of financial markets. Recent trends with respect to concentration are shown in Table 5. The picture that emerges has two fundamental components:

- the shares of total assets, of the deposit market, and of the business- and personal-loan market held by the four largest financial firms – all Canadian banks – declined from 1984 to 1987; and
- a smaller number of financial firms controlled 80 per cent of those same markets and 80 per cent of the assets in 1987 than was the case three years earlier. However, the 1987 figure was still higher than the comparable figure for 1979.

Thus concentration in these markets was definitely lower in 1987 than in 1979. Furthermore, the reduced share of the four largest companies, together with the smaller number of firms accounting for 80 per cent of the market, supports the argument that the recent flurry of mergers, acquisitions, and alliances has strengthened a number of nonbank financial institutions, which are now able to give Canadian banks a better run for their money. It is too early to determine whether the decline of the number of firms accounting for 80 per cent of the market since 1984 signals the beginning of a trend towards greater concentration. Continued monitoring is needed.

At the same time, networking – the arrangement whereby one institution agrees to sell the products of another company – has been increasing, thus contributing to competition: for example, banks, trust companies, and credit unions are now allowed to distribute, on their premises and under certain conditions, the products of securities firms. While institutions are increasingly interrelated through ownership links, separate institutions continue to perform distinct functions. A bank may own a securities firm; but corporate-bond

Table 5

Asset and Market Concentration among Major Groups of Financial Institutions,[1] Canada, 1979, 1984, and 1987

	Proportion accounted for by the four largest institutions			Number of institutions accounting for 80 per cent of:		
	Assets	Domestic deposits	Domestic personal and commercial loans	Assets	Domestic deposits	Domestic personal and commercial loans
		(Per cent)				
1979	54.8	53.8	70.0	12	9	5
1984	52.2	47.7	62.7	16	12	7
1987	47.2	45.2	59.4	14	11	7

1 The groups here include banks, trust companies, loan companies, and life insurance companies with full ownership links. Market concentration is measured with respect to domestic deposits and domestic personal and commercial loans. Of the two methods used here for estimating the measurements, the second is based on a study by the Department of Consumer and Corporate Affairs, in which the degree of market concentration is determined by the number of companies that account for 80 per cent of the output or employment of an industry. The degree of concentration is "very high" when that number is four or fewer; "high," when it ranges from five to eight; "relatively high," when it ranges from nine to 20; "relatively low," when it ranges from 21 to 50; and "low," when it exceeds 50 companies.

SOURCE Estimates by the Economic Council of Canada.

and -equity underwriting and stock trading remain the exclusive domain of its securities subsidiary. This separation is maintained in order to avoid the multiplication of conflict-of-interest situations and to facilitate prudential supervision, thus enhancing solvency and confidence.

The trend in concentration ratios and the increase in networking, together with the new availability of financial services and products on international markets and the growth of foreign-controlled firms within Canada, augur well for the future extent of competition within Canada. These factors had a significant influence on our thinking in preparing the recommendations presented in Part 4.

Commercial/Financial Links

The restructuring that has occurred in the financial sector has also involved, in some cases, the acquisition of financial institutions by nonfinancial (or "commercial") firms, thus rekindling the debate on the development of commercial/financial links. That debate is currently focused mainly on the desirability of "upstream" links – that is, of investments by nonfinancial corporations in the capital stock of financial institutions. Consequently, the discussion that follows is also limited to upstream links.

(The Council addressed the issue of "downstream" links – the holding by financial institutions of equity in nonfinancial firms – as well as the broader issue of the ownership of financial institutions, in its previous Statement on financial markets, *Competition and Solvency*, released in 1986. In that report, we recommended against the development of downstream links and favoured widespread ownership for all financial institutions with assets greater than $10 billion.)

The Current Situation in Canada

Currently, investors with commercial interests do not have significant ownership positions in Canadian chartered banks, credit unions, caisses populaires, or securities firms. The Bank Act imposes strict limits on the ownership of banks: they must be either widely held (Schedule A banks) or wholly owned by a foreign bank or another financial firm (Schedule B banks). Credit unions and caisses populaires are cooperatives owned by their many members. And until recently, nonindustry participation in the ownership of securities firms was prohibited, although all restrictions have now been abolished in all provinces.

Trust and life insurance companies can be incorporated under either federal or provincial legislation. Until relatively recently, commercial ownership of trust and life insurance companies was permitted by legislation at both levels. Several trust companies maintain links with nonfinancial owners; for example, three of the larger ones, accounting for

about 58 per cent of the industry's assets, are subsidiaries of nonfinancial corporations or belong to holding groups that are tied to commercial interests. (Until recently, all three companies were federally incorporated; one has applied for a provincial charter.) Similarly, several of Canada's largest life insurance companies belong to financial holding groups that have commercial interests. On the other hand, many other life insurance companies do not have commercial links, including the mutual life companies that are owned by their policyholders.

Directions of Change

In the current process of regulatory reform, different approaches have been proposed by different institutional groups and governments. Under the proposals outlined in the federal government's 1986 "Blue Book" (entitled *New Directions for the Financial Sector*), the rules governing the ownership of banks and of trust, loan, and insurance companies would vary according to the size of the firm (see box).

At the same time, the governments of Quebec and Ontario have been moving in the opposite direction – towards allowing the establishment of commercial/financial links. This was reflected in Quebec's 1982 insurance legislation and in Ontario's 1987 trust legislation. In October 1988, the government of British Columbia, in its proposal for a new Financial Institutions Act, also expressed its willingness to allow commercial/financial links.

The debate has intensified since the middle of 1988, especially between Quebec and the federal authorities. There are indications, however, that the federal government may adjust its stance. It has been suggested that, should the federal government fail to do so, federally incorporated life insurance and trust companies wishing to attract large commercial investors might well choose to have their charters transferred to a provincial jurisdiction that allows such investments. As we complete the final draft of this Statement, however, the federal government has not officially indicated what its position will be. As well, there are indications that the Quebec government may require that 35 per cent of voting shares of a financial institution incorporated in the province be widely held, thus moving a step closer to the federal position.

The Foreign Experience

Contrary to what is often alleged in the current public debate, commercial firms do not have large ownership interests in any of the 40 largest banks in the world. It is often claimed, for example, that West German and Japanese institutions maintain ownership links with nonfinancial corporations; in fact, however, the only significant links that are found in West Germany are downstream, *not upstream.* In Japan, banks have relations with commercial ventures that do not involve large cross-ownership links; to some extent, these relations are not unlike the links that exist when the executives of nonfinancial corporations sit on the boards of directors of Canadian banks. Thus it is inaccurate to state that the trend internationally is for commercial interests to make large investments in banks.

The absence of extensive upstream commercial/financial links abroad is the result of regulation, historical tradition,

Ownership Rules Proposed in the Federal Government's Blue Book

According to the Blue Book, Canadian banks with a capital base of less than $750 million could be closely held by domestic investors with no commercial interests. In the case of banks with a higher capital base, 35 per cent of the voting shares would have to be publicly traded and widely held. In addition, shareholders with 10 per cent or more of any class of shares would not be permitted to acquire any additional shares, so that their holdings would be diluted whenever new shares are issued. No shareholder would be allowed to hold more than 10 per cent of the shares of an existing Schedule A bank.

The rules applying to trust, loan, and insurance companies with no commercial links would be similar to those pertaining to the banking industry, except that shareholders with 10 per cent or more, but less than 65 per cent, of any class of shares would be allowed to maintain their relative ownership position. For institutions with upstream commercial links, however, at least 35 per cent of the voting shares of the existing companies would have to be publicly traded and widely held when the firm's capital base exceeds $50 million. In addition, nonfinancial companies already holding a significant ownership position in a financial institution with capital in excess of $50 million would not be permitted to increase it. Such companies would only be allowed to acquire or increase a significant ownership position in a financial institution with assets of less than $50 million. In other words, the federal proposals would entail a tightening of the ownership rules for trust, loan, and insurance companies with assets over $50 million, by limiting upstream commercial links and by requiring those companies – even those without commercial links but with assets over $750 million – to have some part of their shares widely held.

and market developments. In fact, the legislative approach towards such links differs widely from country to country. Some countries (the United States, for example) have strict legislative restrictions, while others (including the Netherlands) require ministerial or regulatory approval for the establishment of commercial/financial links or have no restrictions at all (e.g., West Germany). But even in countries where there are no formal restrictions, the regulatory authority may discourage the establishment of commercial/financial links. Such is the case in Italy and in the United Kingdom, where the central banks strongly oppose the development of such links. In several countries, prenotification requirements for the acquisition or transfer of shares in financial institutions act as a deterrent to the development of commercial/financial links.

It should also be noted that these restrictions do not generally extend to nonbanking financial institutions. In the United States, for example, a number of financial institutions are owned by very large nonfinancial corporations, such as Ford, General Motors, or Sears Roebuck.

The Case for . . .

The proponents of a more liberal treatment of commercial/financial links argue that the latter will lead to more competition among Canadian financial institutions, thus strengthening their position in increasingly globalized financial markets. They maintain that commercial/financial links will provide financial institutions with much-needed capital; boost their size – an important factor in their ability to compete; guarantee a strong shareholder presence in their management; enable the owners and the institutions to diversify their sources of business income; and permit the exploitation of the synergies deriving from associations between financial institutions and commercial enterprises – for example, from the joint use of distribution networks or the joint production and selling of complementary products, such as cars and car loans.

The supporters of this position also point out that the restrictions on commercial/financial links act as barriers to entry into the financial industry. They contend that, without the ability to attract investment from nonfinancial firms, trust companies, for example, will be unable to compete with the large banks.

The advocates of upstream commercial/financial links also argue that the Canadian subsidiaries of foreign banks with commercial links in their home country are not considered by the federal authorities as having such links, as long as the owning company is not incorporated in Canada (although it may operate a branch plant in this country). Thus it is possible for a foreign bank with a commercial owner to establish a banking subsidiary in Canada, whereas a Canadian nonfinancial corporation could not do so. (Recall, however, that few, if any, foreign banking institutions have upstream commercial links.)

. . . and against Commercial/Financial Links

Those who oppose commercial/financial links maintain that they lead to abuses of conflict-of-interest situations and to self-dealing between a financial institution and its nonfinancial owners, and that they can result, over time, in additional solvency problems within the institution itself. In effect, the concern here is that a financial institution controlled by nonfinancial interests will extend to its parent company loans or credit that might not have been provided in the absence of the ownership linkage. The critics of commercial/financial links recognize that there is also potential for abuse of conflict-of-interest situations in banking – where there are no commercial/financial links – since bank directors are frequently chief executive officers of companies that have a client relationship with the banks on the boards of which they sit. They argue, however, that a controlling shareholder can more readily impose his will on an institution's activities than an individual bank director.

The opponents of commercial/financial links are also concerned that a financial institution might discriminate against the competitors of its parent corporation and might, knowingly or not, make improper use of information obtained during business transactions with these competitors. The costs of improper or imprudent transactions, in terms of their impact on the solvency of the institution or on the fair treatment of customers, could turn out to be quite high, given the unique role played by financial institutions in maintaining a payments system and in supplying the financing needed to support economic activity.

The opponents of commercial/financial links argue that the stability of the financial system could be threatened by such links, as improper transactions between the financial institution and its commercial partner could jeopardize the solvency of the former. They point out that the danger is even greater in situations where public safety nets – deposit insurance and lender-of-last-resort facilities – have been put into place to protect both depositors and deposit-taking institutions. They note that the removal of the restrictions on commercial/financial links would be tantamount to extending the safety nets to the commercial associates of financial institutions. Any financial difficulties encountered by the parent corporation could well threaten the stability of its

financial affiliate and would thus become a matter of concern to the insurer. In such circumstances, it might be cheaper to rescue the parent company than to reimburse the depositors of its financial affiliate, and that fact could encourage the two related parties to engage in improper transactions, as the costs of insolvency would be borne by the insurer or by the lender of last resort – a situation often referred to as the "moral hazard" of protection. Finally, the argument is often made that commercial/financial links could lead to an increased concentration of assets and power.

Regional Availability of Financial Services

Canadians living outside the central provinces have long claimed that they are poorly served by their financial system. They argue that, because the major decision centres are in Toronto and Montreal, they have less access to vital financial services than those who are located closer to those cities. In particular, many small and medium-sized businesses in the Atlantic provinces and in western Canada believe that they are significantly worse off than their counterparts in Ontario and Quebec. Yet most efforts to create regional institutions to cover this perceived gap have failed; many of the institutions established in western Canada in the 1970s did not survive the boom-and-bust cycles associated with the resource-based economies of that region. Some institutions failed, while others merged.

It is important, in this context, to recognize that the benefits of internationalization and innovation have, until now, accrued mainly to large businesses and to governments and their agencies, not to smaller businesses or to individuals. Moreover, small and medium-sized firms outside central Canada, because they are distant from Toronto's Bay Street and from Montreal's rue Saint-Jacques, probably have less information about, and less understanding of, the potential benefits of the new financial instruments and of dealing in the international markets than do their counterparts in Ontario and Quebec. The growing concentration of international financial activities in Tokyo, London, and New York tends to move decision centres even further from a substantial proportion of Canada's users of financial services. Moreover, with barriers to foreign participation in the Canadian market falling and with competition heating up in international markets, Canadian banks may respond by devoting more resources to developing business abroad, particularly in the U.S. market. In that event, the small and medium-sized businesses in the Atlantic region and in the West could conceivably receive less attention from major Canadian institutions than they now do; the existing differences in the quality and accessibility of financial services available to them and to similar firms in central Canada could well increase as a result.

The health of small and medium-sized businesses is important to the entire economy, especially outside Ontario and Quebec: they account for about 96 per cent of all Canadian firms and for 96 per cent of all net job creation in the country. To avoid a widening of the gap between them and the larger, more centrally located companies, we set out, in Part 4, recommendations aimed at fostering the diffusion of the benefits of internationalization and innovation to customers in small and medium-sized businesses across the entire country.

Solvency of Financial Institutions

Solvency has been a headline issue in recent years. While some of the firms that faced financial difficulties were restructured and purchased by stronger institutions, several others simply went bankrupt, causing important losses to their customers and imposing heavy costs on the insurer – the Canada Deposit Insurance Corporation and, ultimately, the Canadian taxpayer.

Globalization and financial innovation have a bearing on the issue of solvency, in both positive and negative ways. On the positive side of the ledger, some of the innovative products, and others that are still in the design phase, could improve the management of risk. The failures that took place in western Canada were related, in part, to the lack of loan diversification of the institutions involved. By using some of the newer financial instruments, regional institutions could more easily diversify their asset base beyond the borders of the region where they generally originate loans and thus strengthen their viability.

But there is another side to the coin. Globalization and innovation have contributed to increased risks by diminishing the transparency of the financial system and by encouraging investors, borrowers, and financial institutions to assume more risks than they would have had in different circumstances. In addition, the failure of a number of financial institutions has raised questions about the adequacy of regulation and prudential supervision in Canada. These ongoing concerns about solvency can only become more pressing in the current context, where transparency is declining.

Fragmented Regulation

A third issue highlighted by internationalization and innovation is the continued fragmentation of the regulation of

Canadian financial institutions: the federal government and the provinces each have exclusive constitutional authority over certain types of financial activity – for example, banking falls under the jurisdiction of the federal government, while securities transactions are a provincial responsibility – whereas other activities (e.g., the business of trust and life insurance companies) may be subject to regulation from either level of government, depending on the jurisdiction in which a given institution chooses to incorporate. Different types of institutions frequently conduct fundamentally similar, if not identical, functions – for example, banks, trust companies, credit unions, and caisses populaires all accept deposits – but their activities are governed by different pieces of legislation and fall under the authority of different supervisory bodies. Institutions may, through cross-ownership or holding companies, be involved in several distinct financial activities, with each separate activity being subject to a different regulatory authority.

Differences in the legislation of the 11 jurisdictions that now regulate one or more aspects of the financial industry in Canada and between the laws that govern different categories of institutions within the same jurisdiction can be found in many areas. The required minimum capital base differs for a Schedule A bank, a Schedule B bank, a federally incorporated trust company, a trust company incorporated in the province of Quebec, and so on.

Ownership restrictions also vary according to the nature of the institution and the jurisdiction of incorporation. In addition to those variations pertaining to the upstream ownership of financial institutions by commercial and other interests (discussed earlier), there are differences in the rules pertaining to the ownership of one financial institution by another. For example, in the Quebec legislation (and in the federal proposals), cross-pillar diversification through the downstream ownership of financial institutions is permitted; however, Ontario legislation restricts the type of subsidiary that a trust company may own.

With respect to investment powers, while chartered banks, trust companies, and credit unions are all deposit-taking intermediaries, they are not allowed to participate in commercial or personal lending to the same extent. The investments in corporate bonds or equities by federally incorporated trust and life insurance companies must currently meet certain quality tests at the time of purchase. The proposed changes in the Blue Paper would introduce the "prudent investor" approach, under which quality tests would be replaced by the requirement of prudent management of the whole portfolio. The Quebec legislation governing trust and insurance companies follows a "prudent investor" rule. British Columbia is also moving towards such an approach. The Ontario legislation for trust companies includes a "prudent investor" rule but also attaches a list of eligible investments.

The treatment of related-party transactions also differs among jurisdictions. Ontario bans such transactions outright, while Quebec has a selective list of prohibited transactions. British Columbia proposes to adopt a more permissive approach by allowing all related-party transactions but requiring that they be consistent with usual business practice and that they reflect market value.

With so many legal differences with respect to ownership, investment powers, capital requirements, and the treatment of related-party transactions, financial institutions wishing to operate in more than one province must adapt to different requirements, often at great expense.

In designing financial regulation, provincial governments understandably tend to be concerned with the immediate employment and investment opportunities that may result within their own territory from supporting the growth of indigenous financial institutions. Thus the Laurentian and Desjardins groups have been important beneficiaries of the Quebec legislation. The support of provincial activities is probably also at the root of Quebec's disagreement with the federal government over commercial/financial links and of its early opposition to the implementation of the 1987 agreement between Ontario and the federal government on the regulation of the securities industry. Some western provinces have given significant freedom to their own provincially based institutions, in an attempt to encourage their participation in the financing of local economic activity.

While such competitive regulation has its costs, there is no denying that the existence of different jurisdictions has contributed to the modernization of financial regulation in the country. Quebec has played a leading role in many areas, in particular with respect to changes in the pillar system aimed at allowing greater diversification of the activities of financial institutions.

But the financial world has changed radically in recent years, and we believe that transformation has increased both the costs and the risks of competitive regulation. Domestic firms that must absorb additional costs in complying with different and inconsistent regulatory frameworks within Canada are adversely affected in their cost structures. These same factors may also discourage some foreign firms from establishing themselves in Canada. Perhaps more important, however, is the fact that with the rapid growth of globalization and innovation, the solvency risks that were implicit in a fragmented approach to regulation and supervision may

well be much greater today than they were even a few years ago.

The Need for Better Cooperation among Domestic Regulators

The differences in legal treatment would be of less concern if the regulatory authorities cooperated more effectively with one another. Cooperation would involve some rationalization in the administrative requirements pertaining to operations and solvency, but also – and just as important – a more effective exchange of information on an ongoing basis.

The nature and degree of cooperation between the various regulatory authorities are uneven at present. With the exception of one or two provinces, there appears to be a continuing exchange of information between provincial securities commissions, and there are efforts to harmonize prospectus and registration requirements, as well as operating rules. The Investment Dealers Association – the self-regulatory body of securities firms – plays a unifying role across the country.

The provincial superintendents of insurance companies meet on a regular basis and, in recent years, have been joined by their federal counterpart. They deal mostly with supervisory issues rather than with the harmonization of regulations.

There is less cooperation in the supervision and regulation of trust companies and credit unions. A case in point is the "treatment of equals" clause in the Ontario trust legislation, which requires that companies incorporated elsewhere but with operations in Ontario comply with some of that province's regulations in their overall operations. This has irritated other provinces and may have led to a lack of cooperation in some instances.

The Canada Deposit Insurance Corporation (CDIC) – the federal agency that insures the deposits of federally incorporated institutions and participating provincial firms – could play a unifying role by setting uniform standards (with respect to such matters as capital adequacy, solvency, and liquidity ratios) for member institutions. Such standards have yet to be implemented, however. Moreover, the CDIC often relies on other regulatory and supervisory authorities to conduct the examination of insured institutions. As a result, inspections are often not uniform from one jurisdiction to another.

More generally, recent experience has shown that some authorities feel that they should not volunteer information to other jurisdictions, particularly with respect to firms that face financial difficulties. This belief is dictated by what is perceived to be a legal obligation towards the company that supplies financial information on its operations and by the fear that other jurisdictions might overreact. However, the cost associated with a poor flow of information can be very high.

4 Meeting the Challenges

We have seen that internationalization and financial innovation have proceeded at a rapid pace during the 1980s. They have been accompanied by a shift from traditional bank lending to securities-related transactions. They have opened up additional opportunities for both producers and users of financial services by providing access to new geographic markets; increasing portfolio diversification; widening and diversifying the borrowing base of many corporations; expanding business opportunities for financial institutions; and making it possible to improve risk management, both for those who seek protection and for those who wish to profit from risk-taking.

But globalization and financial innovation also involve risks. For many market participants, they have increased the position risk associated with movements in exchange and interest rates, and they have introduced new credit risks. Perhaps most significantly, they have reduced the transparency of financial transactions, making it difficult to determine whether the international financial system of the 1980s is more, or less, vulnerable than the system of the 1960s or the 1970s. And while international cooperation aimed at lowering the risks is more advanced in banking than in the securities field, much remains to be done in both areas.

Canadian borrowers have made extensive use of the new international financial markets, attracted by the aggressive pricing, the diversification potential, and the quality of the services provided. However, Canadians have used new financial products more selectively than their counterparts in the United States or Europe (although in the latter case, the use of those instruments is a recent phenomenon). Moreover, the benefits of internationalization and financial innovation have so far been available to large borrowers and investors only. The retail market has been largely excluded, which raises important issues of public policy about the accessibility of financial services to different groups of Canadians.

As for Canada's financial institutions, they are playing a smaller role than might have been expected in what would appear to be their natural niche. Globally, they are losing out

to the competition. At the same time, Canada's borders are being opened to foreign banks and securities firms. These developments illustrate how much tougher competition has become in this increasingly internationalized industry; and, in turn, they give rise to questions about the kinds of steps that may be needed to strengthen the competitiveness of Canadian-controlled institutions. For example, should Canadian institutions become much larger in order to compete effectively? Can they do so without jeopardizing domestic competition? Are new sources of capital needed to enable Canadian financial firms to expand? Where would the capital come from?

The forces at play in international markets also have a bearing on the solvency of Canada's institutions and the stability of our financial system. In particular, the concerns about reduced transparency lead to questions about Canada's current fragmented approach to regulation and the limited degree of cooperation between the various supervisory authorities.

Thus the forces unleashed by globalization and financial innovation have had a direct influence on the three major factors of efficiency that we identified earlier – namely, competition, accessibility, and solvency. The challenge is to seek the appropriate balance between competition and accessibility, on the one hand, and solvency and confidence in the system, on the other, in the new global context. A concerted effort among nations is required to achieve such a balance, since not all problems can be resolved through domestic policies alone. At the same time, Canada's domestic regulations also need updating. With or without international cooperation, globalization and innovation will continue, and Canadian institutions, investors, and borrowers will be affected. Should Canadians fail to harness the benefits, and minimize the costs, of these developments, they will have to pay a higher price in the long run, especially since many of the required domestic policies are not dictated solely by developments abroad but address some important domestic issues as well.

While most of our recommendations in this Statement are addressed to governments, some are also directed at the financial community itself, at businesses, and, more generally, at investors and borrowers. In order to take advantage of the new opportunities and to minimize the risks that they entail, there must be a joint effort by government and the private sector.

One dominant characteristic of the world economy of the 1980s is the intensification of global competition. That phenomenon is even more evident in the new financial environment. In this Statement, we acknowledge these developments, and we recognize the many benefits that global competition brings – in increasing the efficiency of financial institutions and markets, in broadening the range of financial services available, and in lowering their costs. Accordingly, our recommendations are intended to enable Canada's financial markets to benefit fully from the increased global competition.

At the same time, the dangers of unbridled competition must also be acknowledged. Safeguards must be put into place to support the continued solvency of our institutions, to strengthen the stability of markets, and to protect the consumers of financial services. We offer several recommendations aimed at achieving those goals.

Some of our recommendations, particularly those dealing with the accounting or assessment of risks, may appear to be somewhat technical. The scope of these recommendations is more than technical, however: they are part of a new approach designed to deal with the new financial order. In other words, they are a recognition of the increasingly global nature of the financial-services industry, and they can be best viewed as integral to the search for a new equilibrium between competition and stability on both international and domestic markets. The areas covered by our recommendations are highlighted in the box.

Measures at the Domestic Level

Streamlining the Regulatory Apparatus

If Canada is to meet the challenges posed by the need to improve the overall efficiency of its financial system in the light of recent domestic and international developments, it must first put its own regulatory house in order.

The evolution of Canadian financial regulations reflects the divided constitutional authority in that area, which has resulted in competitive regulation by two levels of jurisdiction. This two-tier system has probably caused changes to occur more quickly in some cases than might have been the case under a single jurisdiction. On balance, the outcome has been an enriched system serving the multiplicity of financial needs of Canadians.

That system nonetheless has a number of weaknesses. Competitive regulation adds to the costs of financial institutions and makes it difficult for firms incorporated under different jurisdictions to compete on equal terms across the country; and recent market developments have given rise to growing concerns about the ability to maintain solvency standards. The large increase in the number of foreign

Road Map to Recommendations

Focusing on Canada, first, measures are proposed to:

- *Streamline the regulatory apparatus and enhance domestic cooperation.* The main issues addressed here are: the insufficient compatibility of the regulation of financial institutions between the different jurisdictions in Canada and the insufficient level of cooperation in prudential supervision (Recommendations 1-3). — Strengthen competition, accessibility, and solvency

- *Remove domestic barriers to internationalization.* One important barrier is the fiscal constraint on foreign investment by pension plans (Recommendation 4).

- *Provide a framework for the entry of foreign financial institutions.* A choice must be made between national treatment and reciprocity (Recommendation 5).

- *Strengthen Canadian-controlled financial institutions.* The issue here is to balance the minimum size needed to compete successfully against concerns about market and asset concentration (Recommendation 6). — Mainly strengthen competition and accessibility

- *Remove barriers to innovation and encourage the development of securitized business loans.* This involves amending existing legislation to allow explicitly for the use of futures, options, and swaps. Because of the potential of securitized business loans as vehicles for strengthening the financing of small and medium-sized businesses and as instruments for financing regional development, and in view of the existing barriers to the development of such instruments, government may need to be more pro-active in respect of this one particular area (Recommendations 7-10).

- *Enhance the solvency of financial institutions through reporting capital requirements and supervision.* In particular, this involves tightening the treatment of off-balance-sheet commitments and position risk, establishing risk-weighted capital requirements for all institutions, requiring that foreign institutions operate in Canada through subsidiaries, and further developing existing safety nets (Recommendations 11-15). While recognizing some potential for strengthening financial institutions through commercial links, and in the absence of clear lessons to be had from foreign experience about the effect of allowing commercial/financial links, we believe it is preferable to err on the side of stability (Recommendation 16). — Strengthen solvency

On the international front, measures are proposed to:

- *Take advantage of the opportunities offered by internationalization.* This involves negotiating with foreign governments and in international forums for the removal of the remaining barriers to internationalization (Recommendations 17 and 18). — Strengthen competition and accessibility

- *Reduce the risks of internationalization and innovation and increase the transparency of financial systems.* This involves increased international cooperation in supervision and better sharing of supervisory responsibility – particularly in the securities area – the development of international accounting standard, for on- and off-balance-sheet items, and the harmonization of capital requirements for international banks and securities firms (Recommendations 19-23). — Strengthen solvency

participants in the Canadian market, the growing international activities of Canadian-controlled firms, and the proliferation of new financial instruments, with their combined effects on transparency, have all contributed to these concerns.

Against this background, the lack of information-sharing between the various supervisory authorities in this country and the inadequate levels of coordination of regulation and prudential supervision are impediments to improving the efficiency of Canada's financial system. In *Competition*

and Solvency, we stressed the urgent need to harmonize the various systems of financial regulation and prudential supervision in Canada.

In delaying action on this front, Canadians are running counter to world trends. Regional economic blocs are attuning themselves to the globalization of financial markets by harmonizing national regulatory and supervisory systems in the financial arena. The European Economic Community, for example, is rapidly moving towards an integrated financial market, with common rules for the access of financial institutions to its component domestic markets, for the listing of companies on stock exchanges, and for the operation of financial institutions in different jurisdictions. On a much smaller scale, six individual exchanges in Australia merged in 1987, to form the Australian Stock Exchange. The exchanges could no longer afford internal rivalry: to meet foreign competition, they had to present a common front. Canadians are in a similar position. They cannot ignore the competition from abroad, particularly from the United States and Europe. Accordingly,

1 We recommend that the federal and provincial governments work together to enhance the compatibility of financial regulation throughout Canada. That harmonization should pertain to such issues as investment powers, capital requirements, related-party transactions, and the distribution of financial products.

Inconsistencies in Canadian financial regulations are found between different jurisdictions, as well as between different categories of institutions that are involved in similar operations but are governed by different statutes within the same jurisdiction. All around the world, the models of financial regulation range from multijurisdictional systems to more unified or even unitary systems (see box). But wherever regulation is fragmented, the recent trend has been towards increased coordination and harmonization.

Canada has much to learn from the experiences of other industrialized countries. In an increasingly globalized world, there is a need for a better-harmonized regulatory and supervisory apparatus, but Canada's constitutional arrangements and political realities – where each jurisdiction guards its prerogatives and nurtures its own institutions – place some practical limitations on the achievement of that objective. Despite past attempts by the federal government and despite appeals by some provincial regulators and the Investment Dealers Association, a national securities commission has yet to be created. Even the establishment of the Canadian Payments Association met with some difficulties, because many saw it as the threat of a veiled takeover by the federal authorities. Similar practical and political limitations also exist in Europe. Indeed, Canada, with its 10 provinces, is in some respects not much different from the 12 members of the European Community. The principles of minimal harmonization and mutual recognition that are being introduced in the Community could apply as well in Canada. Harmonization here would involve an agreement on broad principles that would enable financial institutions to operate from coast to coast in accordance with mutually recognized safety standards while allowing the provinces to maintain differences with respect to specific aspects of the legislation attuned to local needs.

The harmonization of regulations governing investment powers, capital requirements, related-party transactions, and the distribution of financial products would ensure equal competitive opportunities for all financial firms, regardless of the jurisdiction of their incorporation or of the broad category of institutions to which they belong. For example, an Ontario mortgage-loan company would be on an equal competitive footing with a Quebec-based trust company. Agreement on minimum standards on those issues would also ensure that excessive risk-taking or fraudulent activities would not slip through any loopholes in the supervisory systems.

Coordination is nowhere more imperative than in the area of prudential supervision. The presence of different criteria and the lack of information-sharing systems could cause losses to investors, disrupt the efficient functioning of the financial system, and jeopardize confidence in the integrity of its members. Accordingly,

2 We recommend that the federal and provincial governments coordinate the prudential supervision of Canada's financial institutions.

A first step would be the simple sharing of information between different jurisdictions. The scope of that information should include the results of regular or special examinations of financial institutions by, or on behalf of, the supervisory authorities; changes in the conditions of registration; and legal or disciplinary actions taken against any institution.

The sharing of information will not be easy to implement. It will require that the different jurisdictions develop confidence in each other, in the manner in which the information will be used, and in the quality of the information produced. Some steps have already been taken in that direction. An agreement signed in October 1988 by the four western provinces sets criteria for the sharing of information on financial institutions, thus addressing the confidence issue.

Foreign Regulatory Systems

The regulatory arrangements in place in Japan, France, the United Kingdom, and the United States, as well as the regime proposed for the European Community, range from unified systems to multijurisdictional frameworks.

In Japan, a unified system prevails. There, a single government department – the Ministry of Finance – is involved in the regulation of both banks and securities firms through three main bureaus that operate with a degree of autonomy, and supervise the domestic business of banks, their international and foreign-exchange business, and the activities of securities firms, respectively.

France is another country with a relatively unified regulatory framework. The Ministère des Finances plays a major role in the regulation of banks and stock exchanges. Investor protection is handled by the Commission des Opérations de Bourse (COB), which oversees disclosures and deals with issues such as insider trading. The Chambre Syndicale – the executive body of the Compagnie des Agents de Change – looks after the orderly functioning of the markets, enforces regulation, and manages the compensation fund set up to protect the clients of member firms. In 1988, a government commission (the Deguen Commission) recommended that a joint committee of the Ministère des Finances, the Banque de France, the COB, and the clearing houses be given a mandate to analyse the links between the various segments of French financial markets and to ensure the consistency of the regulation of these segments.

In the United Kingdom, securities firms and banks fall under two different government departments – the Treasury and the Department of Trade and Industry. Under the general direction of the Treasury, the Bank of England sets rules and supervises the banks and other institutions that are involved in the wholesale money market. Firms that are engaged in securities activities are supervised by self-regulatory organizations under the Securities Investment Board (SIB) and by this Board itself, which reports to the Department of Trade and Industry. The concept of lead regulator has recently been established, however, with a view to avoiding duplication and ensuring consistency; under this new regime, the Bank of England takes responsibility for the banks and the SIB, for securities firms. In the supervision of the securities activities of banks, the Bank applies SIB rules.

At the other end of the spectrum, the United States and the European Community are examples of multijurisdictional systems. In the United States, banking and securities activities fall under two different jurisdictions. The banking industry itself operates under a dual state and federal system. The Federal Comptroller of the Currency, the Federal Reserve Bank, the Federal Deposit Insurance Corporation (FDIC), and state banking departments are all involved in the supervision and regulation of banks. The regulatory body for most securities activities is the federal Securities and Exchange Commission (SEC). Individual stock exchanges also play a role, however, and the Commodity Futures Trading Commission (CFTC) regulates trading in currency and interest-rate futures. States are responsible for the registration of brokers, the licensing of dealers to sell securities, and the prevention of fraud. To foster much-needed harmonization, the U.S. Report of the Presidential Task Force on Market Mechanisms (the Brady Report), which dealt with the October 1987 market crash, recommended that a formal link be established between the Federal Reserve Board, the SEC, the CFTC, and the various stock exchanges. In addition, there has been a move towards the unification and consolidation of prudential supervision and regulation in an attempt to deal with the severe financial difficulties encountered by the savings-and-loan industry. The Federal Home Loan Bank Board – the body that regulates the savings-and-loan institutions (also known as "thrifts") – has been placed under the direct responsibility of the Treasury. The bankrupt Federal Savings and Loan Insurance Corporation – the insurer of deposits in the thrifts – has been attached to the FDIC, which insures bank deposits. The FDIC has also taken over the management of a number of thrifts facing serious financial difficulties.

The European Community provides an interesting experience. As long as its leaders espoused the philosophy of uniformity and centralization – as expressed in the 1957 Treaty of Rome – nothing much happened, because agreement could not be reached on a common, centralized system. The situation began to change with the adoption of the Single European Act in 1985, which marked the shift to a dual goal of "minimal harmonization" and "mutual recognition." This new approach recognized the individuality of each member country. It led to the establishment of minimum standards – such as uniform risk-weighted capital requirements and liquidity and solvency ratios – but allowed for differences in investment powers and recognized the supervisory and regulatory authority of the jurisdiction of incorporation.

This document served as a basis for an agreement reached by all 10 provinces in January 1989.

But beyond this, there should also be confidence in the quality of the prudential supervision of other jurisdictions. That is why coordination cannot be limited to the exchange of information but must extend to the standardization of the criteria of financial solvency, the development of early-warning systems, the level of capitalization, and the examination of financial firms.

To facilitate the implementation of the two previous recommendations,

3 We recommend that a formal organization of independent provincial and federal regulators – including the federal Office of the Superintendent of Financial Institutions, the Bank of Canada, the provincial securities commissions, and provincial regulators of financial institutions – be established to coordinate the prudential supervision of financial institutions and the efforts to harmonize financial regulation throughout Canada.

Some formal mechanisms of cooperation do exist. Examples in the life insurance and securities industries were discussed earlier. The intergovernmental agreement on information-sharing is another example. But those mechanisms are not yet fully entrenched, nor do they cover all segments of financial activity. In addition, there are no formal links between the regulators of the different major functions; for example, there is no formal mechanism bringing together the regulators of banks and those of securities firms.

The proposed organization would offer a forum for periodic meetings of the regulators. Its work would be supported by various committees whose main objective would be to coordinate the prudential supervision of financial institutions, regardless of whether they are federally or provincially incorporated or whether they are controlled by foreign or Canadian interests. The committees would also seek to establish a minimal harmonized regulatory framework aimed at facilitating coordinated supervision and at providing institutions with equal competitive opportunities from coast to coast, as outlined in Recommendation 1.

The proposed organization is the mechanism by which Canada's regulatory framework would move towards a "minimal harmonization" and "mutual recognition" approach. It would be an appropriate alternative to a single regulatory authority, and it would not entail the lengthy and costly constitutional wrangling that would almost certainly accompany the establishment of a unitary system. It also would give individual authorities enough freedom to develop innovative approaches to regulation.

Armed with a consistent regulatory framework and a more uniform supervisory apparatus, Canadians would be in a better position to take advantage of the opportunities created by the globalization of markets and financial innovation, to improve competition and access within the financial system, and to enhance the solvency of institutions operating in Canada.

Improving Competition and Access

Competition and access within the Canadian financial system can also be improved by such means as

– the removal of the remaining barriers to the participation of Canadians in international markets;

– the opening-up of Canadian markets to foreign firms;

– the strengthening of domestic institutions; and

– increased participation in the process of financial innovation.

Removal of Barriers to Internationalization

A first step in achieving the potential benefits from the globalization of financial activities would be to remove the remaining restrictions on the ability of Canadian institutions – registered pension plans, in particular – to invest abroad. Additional benefits would also be realized from having the institutions book their international business in Canada.

Investment Abroad by Pension Plans — Private pension plans in Canada, which include trusteed pension plans and registered retirement savings plans, are currently limited in their power to invest in foreign securities by the Income Tax Act. That legislation imposes a penalty tax on that portion of foreign investment which exceeds 10 per cent of the book value of the investing fund's total assets, although it allows that 10-per-cent limit to be exceeded by three dollars for every dollar invested in qualifying venture-capital projects. Not only are pension funds large (Table 6), they are also important investors in corporate securities. As a group, trusteed pension plans held $34 billion in corporate shares at the end of 1988. This amounted to some 11 per cent of all shares held by Canadians and to about 41 per cent of all shares held by Canadian corporations and institutional investors. Trusteed pension plans also held $10.6 billion in corporate bonds, or about 11 per cent of the total outstanding.

The assets of trusteed pension plans are invested as follows: 25 per cent in Canadian common shares, 8 per cent in Canadian corporate bonds, and 6 per cent in non-Canadian shares; the rest are mainly held in mortgages and government securities. Almost all of the foreign assets consist of shares. Because of the quality tests incorporated in the rules applying to most pension funds, which restrict their investments to the debt or equity of highly rated corporations, and because of the smaller size of the domestic economy,

Table 6

Assets, Main Functions, and Foreign Activities of Selected Groups of Canadian Financial Institutions, 1987

	Year-end assets	Main functions	Degree of participation in international markets
	(Millions of Canadian dollars)		
Chartered banks[1] Canadian-controlled	369,304	Deposit-taking Lending (personal, business, mortgage) Export and import financing	Extensive
Foreign-bank subsidiaries	43,229	Deposit-taking Lending (mortgage and business) Export and import financing	Extensive, through the parent bank
Trust companies	89,958	Trustee services Deposit-taking Lending (mortgage, some personal)	Limited to a few firms
Credit unions	68,643	Deposit-taking Lending	None
Mortgage-loan companies	77,460	Mortgage lending Deposit-taking	None
Life insurance companies	120,224	Life insurance (individual and group) Annuities Mortgage loans Investment in government and corporate securities	Extensive
Trusteed pension plans[2]	142,110	Pension plans Investment in mortgages	Limited
Investment companies[3]	29,165	Investments	Limited
Property and casualty insurance companies	25,341	Property insurance Casualty insurance	Limited
Financial corporations	20,191	Lending Financial leasing	None
Investment dealers	14,732	Brokerage and underwriting Some deposit-taking	Extensive

1 Includes the worldwide assets of the banks but excludes the assets of mortgage-loan companies associated with Schedule A banks.
2 Assets shown at book value for plans in the private and public sectors.
3 Investment companies include mutual and closed-end funds.

SOURCE Statistics Canada, *Financial Institutions*, Second quarter, 1988; *Bank of Canada Review*, December 1988; and *Supplement to the Canada Gazette*, Part 1, 27 February 1988.

Canadian pension funds often experience difficulty in diversifying their equity portfolios with Canadian equities alone; for that reason, a number of them invest as much as they can in foreign equities. That is particularly true of the funds of federal crown corporations and of large incorporated businesses.

The restriction on foreign investment imposes a cost on pension funds and, ultimately, on their members and sponsors, inasmuch as it prevents them from achieving the highest possible, risk-adjusted rate of return through the international diversification of their portfolios. At the same time, the restriction probably does relatively little to improve the financing of those categories of Canadian business most in need of external funds. Because of the quality tests that must be met, pension funds generally invest in large corporations, which have relatively easy access to domestic and international capital markets and therefore have the fewest problems in securing adequate financing. Those pools of savings are generally not available to firms that have fewer financing alternatives.

The removal of the 10-per-cent restriction would not necessarily lead pension funds to replace the Canadian corporate securities in their portfolios with foreign securities. The experience in the United States and the United Kingdom, where there are few restrictions on the powers of pension funds to invest abroad, provides an indication of what could happen if the Canadian restrictions were lifted. Both U.S. and U.K. pension funds hold almost half of their assets in equities, compared with 25 per cent for Canadian funds. Funds in the United States hold very few foreign assets, probably because they can diversify their holdings within their own country, but foreign securities make up about 15 per cent of the assets of British pension funds, possibly because the smaller size of the British economy offers them fewer opportunities to diversify domestically. Given the even smaller size of the Canadian economy, the removal of the tax penalty on foreign investment might well encourage Canadian pension funds to invest in foreign securities more than U.K. funds do. The increased holdings of foreign equities would be at the expense of government bonds and mortgages.

It is clear that the 10-per-cent limit can no longer be justified by the need to provide equity financing to Canadian corporations. However, the removal of the existing limit would be an important change, which should be implemented in successive steps and should be accompanied by other measures that would enable pension plans to manage their increased foreign investment prudently. Accordingly,

4 We recommend that the Income Tax Act be amended to provide for the gradual removal of the limits on investment abroad by pension funds and that the impact of this relaxation be reviewed periodically.

Extensive investment abroad by pension plans would create the need to hedge foreign-exchange risks, as their liabilities are denominated in Canadian dollars. Most Canadian pension plans currently do not use options and futures. If they maintained this policy in a less restricted regulatory environment, that could severely limit the international diversification of their portfolios, as well as the benefits from such diversification. In the United Kingdom, pension plans use some of the newer instruments, particularly forward rate agreements, to hedge their foreign-exchange risks; some futures and options are also used. To benefit fully from the removal of the 10-per-cent rule, the use of hedging instruments by Canadian pension funds would also have to be allowed.

Some worry about the impact on financial markets of the removal of the 10-per-cent rule. In that context, we note that the annual net revenues of trusteed pension funds – which are equal to over 12 per cent of their assets, on average – are large enough for a significant increase in the limit to be accommodated annually without the need for the plans to sell off any of their existing assets. Moreover, if by investing abroad, pension plans do divert funds that would have otherwise been available to domestic borrowers, those affected are likely to be large corporations and governments, which already have access to international markets. Nevertheless, the fact remains that in the very short run, some borrowers in the domestic bond market – the federal government, in particular – may be adversely affected. We therefore suggest that the limit be raised gradually – by about 2 or 3 percentage points annually. The impact of that change should be assessed every year and reviewed comprehensively by the Department of Finance when the ceiling has reached the 20-to-25-per-cent range.

The removal of the 10-per-cent limit should not be seen as a means of increasing investment in the foreign affiliates of the corporations that sponsor pension plans. Under current pension regulations, pension plans are generally limited to investing no more than 10 per cent of their assets in the marketable securities of either the sponsor or its affiliates. That rule applies equally to foreign and domestic affiliates. In addition, the by-laws adopted by many pension plans prohibit them from investing in the securities of their sponsor or its affiliates.

International Banking Centres — Another step towards bringing the benefits of globalization to Canada is to

encourage institutions to book their international business in Canada. Financial institutions often locate their international operations on the basis of the taxation system in place in various countries – including, of course, exemptions from taxation. In a world where activities are becoming more integrated on a global scale and where financial institutions compete on the basis of comparative advantages, the tax system can be a distorting factor, especially when it is used to subsidize certain activities by exempting them from taxation on income and other sources of wealth. Many countries provide such indirect subsidies for the international operations of financial institutions located within their jurisdiction. This results in a blurring of comparative advantage. The ideal solution would be to do away with these indirect subsidies, but we are a long way from achieving that goal. It is thus understandable that Canada has been attempting to match the subsidies accorded by other countries in a bid to attract, or keep, this sort of activity.

International banking centres, which exempt the income from international operations from taxation, constitute just such a subsidy. The Canadian government has changed the Income Tax Act in order to allow the designation of Vancouver and Montreal as international banking centres (IBCs). As defined by the federal government, the concept is rather limited: institutions in those two cities can accept deposits from, and make loans to, non-residents without paying federal tax on the profits from these transactions; however, profits from investment dealing, letters of credit, and currency transactions are still taxable. But the provincial and federal concepts do not agree. For example, the Quebec government has overlaid the federal concessions with additional sweeteners and eliminated provincial taxes on capital gains, corporate profits, and employee income associated with international financial transactions taking place in Montreal.

Although Canada has accepted the concept of IBCs, they cannot, under the law as it stands, be extended to locations other than Montreal and Vancouver. This may result in opportunities being lost. So far, little additional activity has been generated in Montreal or Vancouver by the designation of those cities as IBCs. This contrasts with the situation in the United States, where there are no federal constraints on the location of international banking facilities (IBFs), which are similar to IBCs. In 1987, more than half of the external assets of banks in the United States were booked in IBFs. In a more flexible environment – one in which financial centres could be established anywhere in Canada – market forces would bring them into being in additional locations.

Those who favour allowing these facilities to be established anywhere in the country argue that the banks would locate them where they would operate most efficiently and that Canada would then derive the greatest benefits from IBCs. Since the international divisions of most Canadian banks are located in Toronto, efficiency consideration would most likely result in IBCs being located in that city. In the United States, 80 per cent of the assets of IBFs are booked in New York.

However, the establishment of IBCs in Montreal and Vancouver has a symbolic value in strengthening financial activities in those cities. In a country like Canada, where the population is dispersed across broad areas, it is important to have strong regional financial centres; restricting IBCs to Montreal and Vancouver is one way of contributing to this goal. Given the ability of modern communications technology to transmit data over long distances, the efficiency loss implicit in this restriction may not be too great.

Since IBCs have only been available in Canada for a short time, more time will be required before an adequate assessment of their effectiveness can be made.

Entry of Foreign Institutions

Maximizing the benefits of internationalization means not only bringing back international activities from foreign countries and attracting new ones, but also allowing the entry of foreign institutions into Canadian markets while facilitating the access of domestic institutions to foreign markets. Accordingly,

5 We recommend that the "right of establishment" be granted to foreign financial firms in all segments of the financial industry, subject to the condition that Canadian institutions be given access to markets in the country of origin of the foreign institutions. Foreign institutions operating in Canada, and Canadian institutions operating abroad, should be subject to "national treatment." However, limits and exceptions to national treatment could be imposed when justified by concerns about the stability of the financial system and the conduct of domestic policies. These limits should be the subject of negotiations with the nations involved.

Two different approaches – "national treatment" and "reciprocity" – have governed the operations of foreign institutions in domestic markets. Under the national-treatment approach, foreign institutions operating in a country must be given the same treatment as that country's domestic institutions. The national-treatment concept is used by the Organisation for Economic Co-operation and Development (OECD) in its code on international investment. It also underlies the free-trade agreement between Canada and the United States,

and represents the approach that is generally being followed by the Canadian government in its negotiations with other nations.

Under reciprocity, two countries agree to let each other's financial institutions operate in their own territory at conditions that are equally favourable for all. Because reciprocity is based on bilateral agreements (initially, at least), its application in Canada could result in similar institutions from different countries having different powers and operating in different sectors of the Canadian financial industry, depending on the powers granted to Canadian-controlled institutions in their home country. For example, under a narrow application of reciprocity, Japanese banks would not be allowed to enter the field of securities trading in Canada, whereas British and West German banks would be given such powers. Thus the administration of reciprocity could add complexity to the process of prudential supervision. On the other hand, under the national-treatment approach, Canadian financial institutions might be unable to engage in all the activities that foreign institutions can perform in Canadian markets.

National treatment often appears unfair on the surface, especially when domestic regulation is more liberal than that of foreign markets. The Canada-U.S. Free-Trade Agreement, which is based on the principle of national treatment, provides U.S. subsidiaries in Canada with broader powers – particularly in the securities field – than they have in their own country. Thus Canadian financial firms operating in the United States face more restrictions than U.S. firms dealing in Canadian markets. A trend towards some convergence – or at least some harmonization – of regulation has recently been evident, however. The Glass-Steagall Act is slowly giving way to a more liberal stance in this area. Thus the Federal Reserve, in a decision handed down in January 1989, authorized five large U.S. bank holding companies to engage in limited securities underwriting and dealing; that decision was immediately applicable to corporate bonds and will be extended to corporate equities after a review of the subject in January 1990. By applying to the Federal Reserve Board, Canadian banks should be able to benefit from similar treatment.

With greater international harmonization of regulation, the differences between national treatment and reciprocity would narrow. While reciprocity appears to be a better bargaining tool, national treatment is not only much easier to apply, but it recognizes the unilateral benefits of foreign entry with respect to access and competition.

While foreign entry brings important benefits to Canadian investors and borrowers, the reciprocal access to foreign markets given to Canadian institutions will be of significant benefit to their business growth and development. In effect, the new regime would be an exchange of "national treatment," or the "reciprocity of national treatment." Foreign financial institutions would be allowed to establish themselves in Canada only if their home country allowed the entry of Canadian institutions and were prepared to give them the same treatment as that afforded indigenous institutions.

Many countries have adopted the principle of reciprocity of entry, and even "reciprocal national treatment." Reciprocity is required, for example, by France and West Germany before foreign banks are allowed to operate in their national territory. It is also a condition that non-EEC countries will have to meet in order for their institutions to be admitted, after 1992, into the single European market in the banking, securities, or insurance industries.

The obligation to extend national treatment does not mean that the treatment must be identical in all respects. A party may accord different treatment for legitimate purposes, such as consumer protection or domestic control over a key industry.

While Canada now allows foreign entry into the banking, securities, and insurance fields, it does not grant full national treatment. The assets of the subsidiaries of non-U.S. foreign banks are limited to 12 per cent of the total assets of Canadian banks; foreigners other than U.S. nationals cannot own more than 25 per cent of the capital stock of Schedule A banks and Canadian life insurance companies; non-U.S. foreign banks need ministerial approval in order to open more than one branch.

The entry of foreign financial institutions into Canada brings benefits to Canadians. The maintenance of a strong domestic sector can be achieved without restricting the entry of foreigners and thus reducing those benefits. Moreover, limits to national treatment could act as a disincentive for foreign financial institutions wishing to invest in Canada the amounts needed to increase competition and to introduce new financial instruments and practices. We believe, however, that the removal of these restrictions to national treatment should be subject to bilateral negotiations with each country involved.

Strengthening Canadian-Controlled Institutions

Firm size is often considered a necessary condition for strength: the larger the firm, the broader its capital base is likely to be and the better is its ability to bear risks. Larger

firms also have better prospects for diversifying their assets and liabilities, a greater capacity for distributing and placing security issues, and a strengthened staying capability in markets when the competition gets tougher and profit margins begin to shrink.

On the other hand, policy makers are often concerned that the emergence of large financial institutions will lead to a concentration of power and a concentration of markets. But concentration should not be assessed solely from a domestic perspective. A concentrated domestic financial system that is open to foreign competition may well behave as a competitive industry. By focusing too narrowly on the degree of concentration in domestic markets, policy makers could endanger the ability of domestic firms to compete internationally and to provide domestic customers with a wide range of financial services. Accordingly,

6 We recommend that when the regulatory authorities assess the degree of competition and concentration in specific financial markets and when they evaluate the potential impact of mergers, acquisitions, and alliances, international sources of competition be taken into account as well as domestic ones.

Size is considered an important factor in the competitiveness of firms in all sectors of economic activity. Recent years have witnessed an increasing number of mergers, which industry representatives have justified by the need for a minimum size to meet the competition successfully.

There have been more than 15 mergers in Canada's financial-services industry since 1984. We believe that domestic concentration is less of a problem in the wholesale market, where Canadian- and foreign-controlled financial institutions compete head on and where Canadian borrowers have direct access to foreign sources of funds. According to the federal Competition Act, the activities of foreign firms should be taken into consideration when assessing the degree of competition in domestic markets. It is also important, however, to acknowledge that, when Canadian borrowers have direct access to foreign markets, that increases competitive pressures at home. Concentration in the retail market should be of greater concern, however – at least in the near future – as that market has not yet been touched by the forces of internationalization. Yet the securitization of loans could contribute to increased competition in the retail market – a point to which we shall return later on.

Financial Innovation

Innovation is another source of industrial strength. Financial innovation has indeed contributed to increased competition and to the opening-up of markets. Given the fact that Canadians have been less prone than their U.S. and European counterparts to use innovative financial instruments, the question arises whether government should encourage that process. Two schools of thought exist in that regard.

The "permissive" approach argues that markets should be left alone: inasmuch as the benefits provided by the new instruments outweigh their costs and risks, the private sector will bring those benefits to the market. The proponents of this approach call attention to the number of innovative instruments that have been developed by private-sector institutions, especially by banks and securities firms in the United States. They point out the innovative work of financial specialists and the rush to bring out new instruments in increasing numbers in order to reap, if only for a few months, the profits generated by them. They also stress that it is difficult to advocate the introduction of specific instruments, as their track record is not proven and very little is known about the risks that they carry and the length of their useful life. They argue that public policy should only seek to remove the barriers to the introduction and development of new instruments.

Those who argue in favour of a more "proactive" approach by government note that the benefits of innovation are usually short-lived and that firms therefore have little incentive to conduct research in this area and to develop and introduce new instruments and practices. That is why, the argument goes, there is a need for governments to take part in the development of new instruments – at least initially, until markets become familiar with them. There are precedents for this. The Bank of Canada contributed to the development of money-market instruments in the 1950s, and the Industrial Development Bank – the forerunner of the Federal Business Development Bank (FBDB) – introduced term loans to businesses. Once other lenders, particularly the banks, caught up with term lending, the FBDB gradually withdrew from this market and remained a lender only to small businesses that had difficulty gaining direct access to the term loan market. Similarly, mortgage-backed securities were developed in the United States by government agencies that have remained very active in that market.

Both the "permissive" and "proactive" approaches have merit, and public policy in Canada should be a blend of both. First, it should aim at removing all barriers, legal and others, that may hinder the introduction of new instruments. Accordingly,

7 We recommend that legislation governing Canada's financial institutions be modified, whenever necessary, to allow explicitly for the use of futures, options, swaps,

and other innovative instruments, within the "prudent investor" framework.

The legislation governing financial institutions – i.e., pension funds; trust, loan, and insurance companies; banks; and credit unions and caisses populaires – is generally formulated in either of two different ways.

In the first instance, the institution can do anything that is not specifically prohibited in the relevant statute. That approach is found in the Bank Act and in most of the more recent legislation, such as the Ontario Pension Benefits Act, the proposed federal trust and loan companies acts, and the Quebec legislation dealing with trust, loan, and insurance companies.

In the second approach, which is found in current legislation dealing with pension funds and with insurance and trust companies at the federal level and in several provincial jurisdictions, the institution can only perform the activities that are specifically allowed in the legislation. A list of the assets that may be held legally is given, generally limiting investment to the "debentures, bonds, stocks, or other evidences of indebtedness" of governments and of financial institutions or business corporations meeting specific earnings tests. These statutes also contain a basket clause allowing the institutions to hold otherwise ineligible assets, with limits usually ranging from 5 to 10 per cent of total assets. Any asset that meets the eligibility requirements at the time of its purchase can then be legally held for its life. There is no legal requirement for the institution to re-evaluate the suitability of assets or to consider the extent of diversification of its portfolio as a whole, except that the legislation usually sets out broad limits on specific asset classes. Assets held under basket clauses are subject to the requirements of prudent investment – a principle that is well established in common law and in the Quebec civil code.

Most of the recently proposed or enacted pieces of financial legislation no longer contain a legal list and specifically require prudent-investment standards. Not only must an asset be "prudent" at the time of purchase, but it also must be re-evaluated periodically, as must the status of the entire portfolio of assets with respect to diversification. The newer statutes sometimes set limits on the share of total assets that may be held in the form of specific asset classes. It is not clear, at this time, to what extent the requirement that the whole portfolio be subject to re-evaluation will encourage financial institutions to make greater use of innovative instruments in order to hedge their risk and increase their returns.

Many statutes do not indicate clearly whether new instruments may or may not be used. This has led institutions to shy away from innovative financial products. For example, many pension funds and other financial institutions do not use options and futures to hedge their investment risks, either because they require their "basket" for other assets or because they are unsure whether or not the use of such instruments is allowed. The ambiguity in the legislation should be removed in order to make it possible for all kinds of instruments to be used where appropriate. But the use of the new instruments must remain subject to the notion of prudent behaviour.

The lack of adequate internal mechanisms to control the use of new instruments has been mentioned by many observers as a serious risk factor. It is important to ensure that institutions will not engage in activities for which they have not adopted such control mechanisms. The institutions should have internal rules that clearly spell out the limits on position-taking, by type of instrument, distinguishing between hedging and speculating activities; they should also adopt rules on the mechanisms for reporting to senior management. In addition, procedures are needed to evaluate and price the risks associated with various commitments.

Indeed, many well-established institutions have already adopted such mechanisms – some of them after having suffered heavy losses. As these instruments become more widely used and provide increased flexibility to many more institutions, it is important to ensure that their potential misuse will not endanger the stability of the financial system. With adequate internal control mechanisms in place, the greater use of innovative instruments will contribute to greater competition and diversification in financial markets and to the provision of a broader range of financial services to borrowers and investors.

A number of businesses and individuals – particularly small and medium-sized businesses and smaller investors – are not familiar with options, futures, swaps, and other new instruments. In Canada, crown corporations have often participated in the dissemination of information. It is a limited but useful task that government can play, and it can be viewed as part of the permissive approach. Accordingly,

8 We recommend that federal and provincial financial crown corporations assist small and medium-sized firms and investors in understanding the role played by new financial instruments.

At the federal level, that task is consistent with what the Federal Business Development Bank has been doing, particularly under its CASE (Counselling Assistance to Small

Enterprises) program, which is aimed at helping small and medium-sized businesses solve their financial and nonfinancial management problems. The FBDB should extend this program to assist firms interested in establishing the internal structure and control mechanisms needed to manage the use of new financial instruments.

In most areas of innovation, government should do no more than remove the impediments to the development of new instruments and disseminate information on the risks and benefits that are attached to them. If appropriate changes were made to the legislation governing the investments of pension plans and life insurance companies in order to clearly allow the use of innovative instruments, the development of an organized financial-futures market in Canada might conceivably be successful should these institutions become more involved in such activities.

Securitization of Business Loans — A more active approach is called for, however, in the development of asset-backed securities. That is because the benefits of these instruments extend beyond the main players – financial institutions, investors, and borrowers. Asset-backed securities have the potential to become a key instrument in financing the development of Canada's regions and in bringing the benefits of internationalization to the retail market.

In particular, if it proved possible to develop securitized business loans, this could be beneficial for the development of the regions and of businesses (especially medium-sized), and it would strengthen Canada's financial institutions by enabling them to use their capital base more efficiently. It would raise the level of competition in the business-loan market – the most concentrated of all financial markets in the country – by bringing in new lenders and new investors. It would facilitate the participation of trust and insurance companies in that market, once federal and provincial legislation has been amended to give them the power to do so.

Effective in 1992, new capital requirements will raise the cost of holding commercial loans on a bank's balance sheet, particularly in relation to its other assets (such as mortgages). This could reduce the supply of funds to businesses – small firms, in particular – unless new investors are brought in. Individual loan sales by banks would not be a viable alternative, since the holders of large portfolios, who seek to invest large sums of money, would be unlikely to be interested in purchasing such loans. That is where securitization could play an important role.

Surveys of small and medium-sized businesses in the United States, the United Kingdom, and Canada have revealed that they are particularly concerned about the cost of borrowing and the extent of the knowledge of their business by the officers of financial institutions. The surveys show that large U.S. banks offer lower-cost financing than the smaller local banks but that the latter know their customers better and often require less collateral. The securitization of business loans in Canada might enable the smaller local financial firms, which are better attuned to local needs, to originate loans and yet charge borrowers a rate similar to that of the larger institutions. Securitization could also improve the availability of funds outside urban centres. Local institutions would be able to participate as originators and to sell their loans to packagers for resale to large funds.

The securitization of business loans is a big challenge. A major stumbling block is their lack of homogeneity. Business loans differ widely with respect to maturity, collateral, interest rates, and the creditworthiness, sector of activity, and location of the borrower, to name but a few factors. This heterogeneity might be overcome either by a guarantee of the principal and of timely payment or, alternatively, by the establishment of norms – with respect to maturity or to collateral, for example – that would impose a greater degree of standardization on business loans. While such standardization would result in fewer loans being tailored to the borrower's financial structure, that is perhaps a small price to pay for the continued availability of financing at better terms and at a lower cost.

There are several components in the securitization process: origination; packaging; the establishment of a trust; the selling of shares; credit enhancement; monitoring; and market-making. Origination and monitoring would be left in the hands of the institutions that have the closest contact with the borrower – namely, banks, credit unions, trust companies, and even insurance companies. The smaller trust companies and credit unions would likely be the first lenders to take advantage of this program, and the banks would likely participate at a later stage. The selling of the units would be handled by securities firms, while a trust company would be used as trustee and transfer agent. Trust companies, life insurance companies, credit unions, pension funds, and individuals would be the likely investors.

Credit enhancement is an important part of the process of securitization of business loans. Different methods of credit enhancement have been used at one time or another in the securitization of mortgage, car, or business loans and credit-card receivables (see box on page 44). One option that has often been used, particularly in the first stage of a program, is for a government agency to provide the investors in the pool with a guarantee of timely payment of interest and principal. Such a guarantee would contribute to the required

standardization; it would also exempt the issues from prospectus and registration requirements.

Methods of Credit Enhancement

1 Insurance or letter of credit issued by a private institution.

2 The first losses (10 to 15 per cent of book value) to be assumed by the originator of the loan.

3 Overcollateralization – a larger value of loans included in the pool than the value of shares sold.

4 Issuing of several tranches: a senior and junior security where payments are made first on the senior security.

5 Guarantee of timely payment of interest and principal, with a limit on the total amount that can be guaranteed each year.

On the other hand, the guarantee would also entail potential costs. The quality of the loans originated for the purpose of securitization could be seriously affected by the guarantee, and any resulting large losses would have to be covered out of public funds. No government guarantee was involved in the securitization of U.S. car loans or credit-card receivables, however. Instead, letters of credit (commitments by banks to cover eventual shortfalls in payments), overcollateralization (the inclusion in the pool of loans of a total value greater than the value of the pool, so that investors would not be adversely affected by defaults on some loans), or both, were used.

Some of the other methods of credit enhancement may turn out to be costly, in the case of business loans. For example, because of the lack of standardization, the determination of the required level of insurance coverage might necessitate an evaluation of the creditworthiness of each borrower. This could be avoided by the setting of norms that business loans must meet to be included in securities pools. The commitment by the originator to cover the first losses – another method of credit enhancement – might defeat the original purpose of securitization, which is to move the loans off the firm's balance sheet. In any event, further research is needed to find the appropriate balance between the various methods of credit enhancement and standardization, based on their costs and their potential negative impact on the securitization process.

If a government guarantee is needed, for example, in conjunction with other methods of credit enhancement, a cap should be placed on the amount that could be guaranteed each year. And an appropriate fee should be charged for the guarantee. While it would be easier to launch a program of business-loan securitization with a government guarantee, we are not persuaded that this would be beneficial in the long run. As already mentioned, standardization could be achieved through the establishment of norms that loans would have to meet to be included in the pool. The norms would impose much-needed discipline in the origination of loans, although they might restrict the volume and types of loans that would be securitized. But in the early stages, that would be a small price to pay in order to ensure the success of the program and to limit the role of government.

Finally, market-making could be undertaken by securities firms or a government agency, or both.

The securitization of business loans, by improving the functioning of domestic capital markets, would help to fulfil two important goals of public policy: it could bring needed financing to businesses – in particular, to small and medium-sized firms; and it could ensure a continuing supply of funds to the regions. If they were sold on international markets, securitized business loans could bring the benefits of globalization to the retail market. The development of this instrument should therefore be actively pursued.

The role that government must play here is that of a catalyst, in order to get the program off the ground. In the United States, the securitization process was launched in 1970 by the federal government and by government-sponsored agencies that introduced the "mortgage pass-through." This had a demonstration effect by showing that securitization does work and can be profitable. Today, the private sector is active in the securitization of mortgage loans. Credit-card receivables and car loans were securitized without government assistance. Because of the specific difficulties involved in the securitization of business loans, however, government agencies in the United States are again playing the role of a catalyst.

In Canada, the experience of the Federal Business Development Bank (FBDB) in term lending and of the Canada Mortgage and Housing Corporation in mortgage lending and insurance shows that government intervention in a developmental role is often viewed as being temporary, until private-sector institutions are willing, and able, to take over. The securitization of business loans would be subject to the same treatment.

Because of the important role it played in the development of business financing, because of its expertise in the area, and because of its branch network from coast to coast, the

FBDB is the channel through which the federal government could act as a catalyst in the securitization of business loans.

9 We recommend that the Federal Business Development Bank (FBDB) contribute to the development of a market for securitized business loans in Canada by:

a) packaging loans originated by private lenders into securities pools for sale to investors at a price that would provide a fair market remuneration for all participants in the process;

b) establishing norms for loans to be accepted in securities pools;

c) establishing, in conjunction with private-sector firms, methods of credit enhancement;

d) standing ready, if necessary, to maintain a secondary market in shares of the pool.

The involvement of the FBDB in any or all of the above-mentioned areas should end as soon as the private sector shows its readiness to take over.

While the FBDB is probably in the best position to develop securitized business loans, it should make its newly acquired expertise available to provincial agencies lending to businesses. Accordingly,

10 We recommend that the provincial crown corporations involved in lending to businesses take an active part in the development of securitized business loans.

Enhancing the Solvency of Financial Institutions

Internationalization and financial innovation have done much to improve the services offered to Canadians and to broaden the range of products available to them. In important respects, however, they have also added to the risk of insolvency or loss of stability of the financial system by making it less transparent. It is now more difficult to follow the growing volume of trans-border financial transactions, and the proportion of off-balance-sheet transactions is much larger than it used to be. The regulators, accounting firms, and auditors interviewed by the Council's staff view this lack of transparency as a serious problem. There are a number of steps that can be taken domestically to lessen the loss of transparency and thus maximize the net benefits of increased competition and the opening up of markets. They include:

- better disclosure by financial institutions;
- better monitoring of the risks that they assume;
- the imposition of capital/asset ratios;
- requiring foreign firms to operate through subsidiaries;
- the strengthening of safety nets; and
- limiting the links between financial institutions and nonfinancial firms.

Improved Disclosure

With respect to the first of these steps,

11 We recommend that Canadian financial institutions be required to report to the relevant supervisory authorities, on a quarterly basis, all off-balance-sheet commitments and to provide, on demand, access to information pertaining to the counterparties to over-the-counter transactions such as swaps, options, and futures.

A number of regulatory authorities in Canada have the power to request such information, but they seldom use it. A serious impediment to the effective prudential supervision of financial institutions is the inadequate amount of information on their position and credit risks, largely resulting from the fact that many such risks do not appear directly on balance sheets. A first step would be for institutions to disclose their off-balance-sheet commitments. A second step would be to reveal, if necessary, the identity of counterparties – that is the individual, corporation, or other financial institution with which the institution has entered into a transaction (an interest-payment swap or a futures contract, for example). This type of information is no different in essence than that which is obtained through the selective audits currently performed on the credit files of banks. The disclosure requirement should apply to banks, securities firms, trust companies, and life insurance companies. It would require the establishment of standards of reporting pertaining to the new instruments.

Improved Monitoring

With improved disclosure, the regulatory authorities would be in a better position to monitor the risks assumed by financial institutions. With the development of securitization and the greater participation in securities trading by banks and other institutions, position risk has grown in importance relative to credit risk. Most of the supervision and prevention measures in place are geared to credit risk, however, as in the case of the risk-weighted capital/asset ratios of the Bank for International Settlements. In Canada,

the regulatory authorities have generally not attempted to assess the extent of position risk assumed by the financial institutions or to establish methods to control that risk – except in the securities industry, where position risk is taken into consideration in the establishment of capital requirements.

In order to assess and monitor position risk, as well as the risks attached to many off-balance-sheet items, it will be necessary to develop standards and methods to measure them. We recognize that this is a very difficult task and that most institutions do not know how to measure all of these risks. Nevertheless, it is necessary to work towards the development of such standards and methods. Therefore,

12 We recommend that Canadian supervisory authorities set in place methods to monitor the position risk assumed by financial institutions.

This type of monitoring might require taking into account tradable assets and liabilities on and off an institution's balance sheet, the extent to which assets and liabilities are matched, the past variability in the price of the assets, and its expected future variability.

Capital Requirements

The disclosure and monitoring of risks are only a first step. Risk-taking must also be managed without impeding competition. We believe that capital requirements should be established for all financial institutions on the basis of an assessment of the risks that they assume. But Canada cannot move alone. First, in a globalized environment, the stability of the Canadian financial system depends increasingly on the solvency of the large foreign institutions. Their risk-taking should also be managed adequately. Secondly, if the requirements imposed on Canadian institutions were too strict, that would put them at a competitive disadvantage with respect to foreign firms. Thus it is of paramount importance that capital requirements be imposed on all institutions and that Canadian requirements be consistent with those imposed by international agreement on institutions that operate in world markets. Accordingly,

13 We recommend that, as procedures for measuring and monitoring risks are developed, capital requirements be established for all Canadian financial institutions on the basis of all of the risks that they assume, and that these requirements be, as much as possible, consistent with those imposed by international agreement on institutions that are active on international markets.

Capital requirements that are established on the basis of the risks assumed by the institution play a dual role. First, they act as a cushion that the institution can use to protect itself and its customers in periods of economic difficulties. Second, they are a form of control over the risks assumed by the institution. But the 8-per-cent, risk-weighted capital requirement that Canadian banks must meet by the end of 1991 only takes credit risk into consideration, whereas the capital/asset ratio demanded of securities firms does not take that type of risk fully into account. The capital requirements for those two categories of institutions should therefore be modified in order to take into consideration both credit and position risks. There are currently efforts, under the aegis of the Bank for International Settlements, to extend risk-weighted capital/asset ratios so as to include the risk of price variations. In addition, risk-weighted capital requirements should be extended to all institutions – including trust companies and credit unions, both of which are involved in operations quite similar to those of banks.

Foreign Entry through Subsidiaries

The structure under which foreign firms are allowed to operate in Canada is another important issue that has a bearing on the stability of the financial system. Currently, foreign banks and securities firms can only enter the Canadian market by establishing subsidiaries, while foreign life insurance companies may enter through a subsidiary or a branch.

Foreign institutions strongly object to the requirement to establish subsidiaries, arguing that operating and administrative costs are much lower for branches than for subsidiaries. Theoretically, a branch does not need an accounting system or a head office separate from that of the parent company; and fewer auditors are required to review its financial situation. In addition, branches can offer larger loans than subsidiaries, because they are able to draw directly on their parent institution's capital. With branches, the institution can allocate its capital resources more efficiently on a worldwide basis. As branches are still part of their parent company, they are less likely than subsidiaries to run into difficulty as a result of adverse economic conditions in the host country. The activities of a branch carry the full guarantee of the parent company; when the parent is a major international institution, that fact may enhance confidence in the financial system of the host country.

However, other factors militate against the establishment of branches, as opposed to subsidiaries. As the branch is an integral part of the parent company, it is subjected to regulation from the home country, which may, at times, limit the

range of its activities. For example, the branches of U.S. banks cannot be involved in the securities business; until recently, that was also true of Canadian banks. To avoid these restrictions, U.S. and Canadian banks have established subsidiaries in London. From a regulatory point of view, it is easier to supervise a subsidiary, which must have its own set of books, administrators, and board of directors. Moreover, subsidiaries are more insulated from any financial difficulties that the parent company may encounter.

Among OECD countries, only Canada, Finland, Norway, Sweden, and Australia require that foreign banking institutions establish subsidiaries to operate in their domestic markets. However, to be recognized as a European institution in the context of post-1992 Europe and thus gain access to the whole Community, a non-EEC institution will be required to establish a subsidiary in at least one of the 12 member countries.

Also, in a number of countries the conditions attached to the establishment of a branch tend to blur the distinction between branches and subsidiaries, especially with respect to the imposition of capital equivalences. In the United States, for example, deposits amounting to 5 per cent of risky assets must generally be kept by the branches of foreign institutions with the Federal Reserve or with a recognized deposit-taking institution within the state where they are established. In France, some form of capital requirement and a formal undertaking from the parent company are required. In Japan, a foreign securities firm that intends to establish a branch is required to deposit a performance guarantee, and branches must maintain a certain level of assets. In other cases, the range of activity that can be pursued by branches is limited; in West Germany, for example, only subsidiaries may be the main manager of Deutschemark issues.

Thus the lesson that can be drawn from the foreign experience with respect to the form of penetration of domestic markets by foreign institutions is mixed. In deciding on the preferred form, the institutions focus on the costs of conducting business, whereas the regulatory authorities are more concerned with stability.

As the international financial world is in a state of permanent flux, the stability argument takes on greater importance. Because the respective responsibilities of the host country and the home country in the sharing of supervision are not always well established and because there are few commonly accepted standards, a greater onus is placed upon the host country to protect the operations of its own financial system, of which foreign firms are an integral part. While supervising the branches of foreign institutions is not an impossible task, a survey of Canadian regulators has revealed that subsidiaries can be supervised more easily and more effectively. Until there is greater coordination in the supervision of different categories of financial institutions and greater harmonization of regulation at the international level, prudential considerations argue in favour of the subsidiary route. Accordingly,

14 We recommend that foreign financial institutions wishing to operate in Canada be required to do so through subsidiaries unless they confine themselves to transactions with non-residents.

Because solvency considerations are a source of concern to Canadian regulators only inasmuch as they affect Canadians, foreign-based institutions that limit their activities to transactions with non-residents either through international banking centres or through other means should not be constrained to operate through a subsidiary. Furthermore, the branches of foreign life insurance companies currently operating in Canada should be allowed to operate under a "grandfather clause."

Safety Nets

Safety nets are the fourth element of a domestic package aimed at maintaining confidence in the financial system. Historically, deposit insurance was introduced to maintain the confidence of depositors – in particular, smaller, less-sophisticated depositors – in the banking system. The lender-of-last-resort function was aimed at ensuring that the liquidity problems of banking institutions would not disrupt the payments system.

Both of these measures were introduced because of the "fractional reserve" nature of the banking system – i.e., of the fact that only a fraction of the deposits entrusted to banking institutions are kept in the form of cash or very liquid assets. Because most of the money is lent out in the form of commercial, mortgage, or personal loans, a bank would be unable to meet a request to refund all deposits simultaneously. It is this characteristic – and the importance of banks in the financing of economic activity and in the maintenance of a payments system – that led to the establishment of deposit-insurance funds and of a lender-of-last-resort facility.

In most countries, the central bank assumes the role of lender of last resort. While not all countries have deposit-insurance funds, they are becoming more common. West Germany, the United Kingdom, Japan, and the United States have deposit-protection schemes, although their coverage differs with respect to the amount and to the involvement of

the depositor in a co-insurance scheme. When integration is achieved in 1992, most members of the European Community will be driven to set up such funds. In *Competition and Solvency*, we supported the continuation of the coverage at its existing level by the Canada Deposit Insurance Corporation.

With the growing importance of securities trading, the question arises whether protection funds and lender-of-last-resort facilities should be made available in the securities industry. Securities firms do not currently operate on a fractional-reserve system, and they are required by law to segregate the securities kept on behalf of customers from their own; a similar requirement exists for cash deposits. The clientele of an investment dealer should therefore be unaffected by any financial difficulties faced by the firm, and the presence of a contingency fund serves mainly to protect the customers from fraud. However, because securities firms have grown in relative importance within the financial system and because they are counterparties to many contracts of other financial and nonfinancial firms, the failure of one of them could put a number of contracts into jeopardy and could adversely affect the stability of the financial system.

The October 1987 crash of the stock market is an example of the extraordinary circumstances in which this could occur. The failure of a major institution at that time would have had serious consequences for the stability of the whole system. In a coordinated effort, the central banks of the major developed countries injected extra liquidity into the world economy in the days following the crisis. That liquidity finally ended up with securities firms and enabled them to weather the crash.

It is important that central banks continue to look at the financial system as a whole, and not just at the banking sector, in assessing the liquidity needs of the economy and in reacting to the strains that develop in various segments of the system. It is equally important that the clients of securities firms be protected against fraud, so as to maintain confidence in all parts of the financial system. To that effect, some form of protection fund is needed. Such funds exist in France, the United Kingdom, and the United States, where they are operated by private associations and self-regulatory bodies. In Canada, the National Contingency Fund, which is run by the Investment Dealers Association (IDA) and the stock exchanges, is funded by contributions from the members of the association. The NCF protects noninstitutional customers only. It has historically been able to meet its requirements. After the failure in 1987 of a medium-sized securities firm, however, the fund had to make a "special call" on its members for additional funds in order to meet its liabilities fully and replenish its cash resources.

Because protection is mainly needed for the less sophisticated customer, a limit should be placed on coverage. No such limits currently exist in the National Contingency Fund. In the United States, the Federal Deposit Insurance Corporation covers bank depositors up to a maximum of $100,000, and the investors' protection fund has a limit of $500,000 per customer, per failure (including a $100,000 maximum for cash). In Canada, the CDIC insures bank deposits to a maximum of $60,000. Using that figure and the five-to-one ratio between cash coverage and the total coverage in place in the U.S. securities industry,

15 We recommend that the National Contingency Fund, operated by the Investment Dealers Association and Canada's stock exchanges, cover losses by the noninstitutional customers of securities firms, not exceeding $300,000 per occurrence per customer (with a maximum of $60,000 for cash deposits). The fund would continue to be operated by self-regulatory organizations and to be financed by contributions from member firms. It should have the authority to impose financial standards on them.

The ability to impose standards on the participating firms is a condition that is often attached to protection schemes – to Canada's deposit insurance, for example – so that the insurer will not experience undue losses because of a lack of such standards. Standards enhance the solvency of financial institutions. The Council believes that standards should be set for all categories of institutions, not only because they enhance solvency but also because they reduce the "moral hazard" associated with protection funds.

Any safety net carries with it a certain degree of moral hazard, in the sense that it could encourage institutions to undertake extra risks and shift the costs of their actions to others – i.e., to the insurer or to the lender of last resort. In the case of the National Contingency Fund, those costs would be shifted to the other securities firms since, as a group, they finance the fund. Risk-weighted capital/asset ratios, disclosure requirements, and prudential supervision lessen the risk of failure and thus lessen the probability that recourse to the safety net will be required. And when an institution does fail – and it should be allowed to fail if it is unprofitable or improperly managed – management and shareholders should absorb some of the losses associated with their actions, while depositors and clients should be protected up to agreed limits. In this way, the incidence of moral hazard is minimized and the benefits of maintaining confidence in the system clearly justify the existence of safety nets.

The Ownership of Financial Institutions by Nonfinancial Corporations

In examining the issue of commercial/financial links, the Council recognizes that there are strong differences of opinion among governments within Canada and among interest groups and analysts. Our advice here is addressed to both levels of government, in the firm belief that wise decision-making is more likely to result from a careful analysis of the facts and the options than from competition between the different levels of government.

Because there are strong arguments and counterarguments on both sides of this issue, it is not an easy matter to decide where the public interest lies. As noted in Part 3, those who support the existence of upstream commercial/financial links emphasize the need to open the financial system to competition. Those who oppose the existence of such links stress the need for solvency, fair treatment, and the stability of the financial system.

From the simple perspective of promoting competition and opening up markets, it could be argued that nonfinancial firms should be allowed to own financial institutions without any reservations. From the simple solvency perspective, commercial/financial links should be banned outright. The first position would enhance the competitiveness of various financial institutions but would, at the same time, jeopardize the long-term stability of the financial system. The second would buttress solvency but stifle competition. Both are extreme positions.

Both competition and solvency are important elements that contribute to the efficiency of a financial system, and some balance must be found between them. This has led us to search for some middle ground that would provide a better balance between the objectives of competition and solvency. In the discussion that follows, we set out two possible options – one that stresses the concern for solvency, and one that emphasizes the competition objective. We do not attempt to sketch out all the design details of those options but merely present them as illustrations of the more fruitful middle ground in this debate. We also indicate which option we prefer, and why.

Option 1: Allow Commercial/Financial Links but Regulate Behaviour — Those who support the development of upstream commercial/financial links readily acknowledge the dangers referred to by critics and recommend the implementation of measures to lessen the risks of imprudent or improper behaviour on the part of the financial partner in such arrangements. To reduce those risks, it would be necessary to ensure that all transactions between financial institutions and their nonfinancial partners take place at market conditions. Thus the first option would allow the development of commercial/financial links but would establish mechanisms to monitor and review non-arms'-length transactions. This would involve the establishment of a review committee of outside directors to scrutinize such transactions fully. It would also involve more frequent auditing of the operations of financial institutions that maintain upstream commercial links.

For example, the regulatory authority might conceivably send auditors to the financial firms on a monthly basis to ensure that all transactions between related parties are undertaken in a proper and prudent fashion reflecting market conditions. The cost of this extra surveillance would be covered by special levies on the institutions that maintain commercial links.

Such policing requirements – and the bureaucratic apparatus that would accompany them – would likely be extensive. They might well slow down the development of commercial/financial links. Moreover, we believe that no amount of inspection and monitoring can be totally effective in preventing improper or imprudent transactions if the controlling partner is determined to circumvent the law. Indeed, when such abuses do occur, they often become known to the supervisory authority only after the fact. In other words, allowing commercial/financial links to develop brings in new systemic risks that cannot be fully eliminated. It is implicit in this option that Canadians should be prepared to live with these additional risks and that accepting those risks is justified by the benefits that will derive from increased competition.

To reduce the risks even further, we considered the possibility of banning all financial transactions between financial institutions and their nonfinancial partners. An all-encompassing ban would, however, deprive the partners of the synergies that such links could provide. Perhaps more important, it would prevent the reallocation of financial resources between various segments of the related businesses as opportunities develop. Without the ability to reallocate resources, businesses cannot be run efficiently. Thus an outright ban on financial transactions between financial and nonfinancial partners would take away many of the benefits that could accrue from commercial/financial links. For that reason, we have not retained it as a viable alternative.

In the current context, allowing the establishment of commercial/financial links would meet the concerns of those who wish to encourage more flexibility in the ownership of trust companies and life insurance companies. One consequence of this option, however, is that it would be

necessary to reconsider the rules governing the ownership of all categories of Canadian financial institutions. As long as Canadian banks, mutual life insurance companies, and credit unions and caisses populaires are required, either by legislation or by their corporate structure, to be widely held, they cannot establish upstream commercial/financial links. But if, indeed, the development of such links is an important contributor to the ability of a financial institution to compete, the banks, financial cooperatives, and mutual life insurance companies would be put at a competitive disadvantage relative to other financial institutions. It should thus be kept in mind that implementing this option would sooner or later require a revision of the ownership structure of all Canadian financial institutions, including the chartered banks.

Option 2: Give the Priority to Solvency Considerations — The second option is based on the assumption that although there may not be immediate costs and disruptions from the ownership of financial institutions by nonfinancial corporations, there are longer-term dangers associated with such links. As the existing commercial/financial links mainly involve large reputable firms in a sound financial position, it is recognized that the risks of immediate disruptions are rather remote. That situation could well change, however, as more commercially-owned financial institutions are established; many nonfinancial companies are highly levered and vulnerable to downturns in the cycle. Our concern is with the kind of corporate behaviour that could occur when the commercial enterprise is facing financial difficulty – when the temptation to cut corners and obtain interim financing from a captive source in order to surmount temporary difficulties can become very powerful.

To avoid these risks, the second option would prevent deposit-taking institutions from developing substantial ownership links with nonfinancial investors, but no constraints would be imposed on other institutions. The restriction would apply to all deposit-taking institutions – banks, credit unions and caisses populaires, trust companies, and mortgage loan companies – because of their special role and of the protection that they receive from public safety nets. If other institutions were to accept deposits or instruments deemed to be deposits, they would become subject to that restriction as well. Under this option, provincial and federal legislation would preclude investments by nonfinancial interests (or a group of associated nonfinancial interests) in deposit-taking institutions whenever the investment is equal to 10 per cent or more of the capital stock of the target company. "Grandfathering" rules would apply to those deposit-taking institutions which already have upstream commercial links.

As for financial institutions that do not take deposits, the legislation should require that, in their dealings with the public, they make clear that they are controlled or largely owned by a commercial investor. Scrutiny of non-arms'-length transactions by independent members of the board of directors and by public supervisory authorities, as set out in Option 1, would also be appropriate.

Analysing the Options — Over the past 10 to 15 years, the world has been moving towards global competition at a quickening pace. Barriers to cross-border capital flows have been removed in all major countries; foreign firms can now more easily establish operations in the domestic markets of most industrialized nations. Large borrowers tap sources of funds available anywhere in the world; investors are induced to take a more global view of their affairs.

In this Statement, we have recommended measures to lower further the barriers to international competition and to improve the access of foreigners to the Canadian market and of Canadian institutions to foreign markets. We have also recommended the introduction of instruments, such as securitized business loans, that would enhance the competitiveness of the very institutions – the smaller trust companies, for example – that are currently seeking permission to develop links with nonfinancial firms. In addition, we believe that the securitization process has the potential to strengthen financial institutions with a regional base. In other words, throughout this Statement we have recognized the need for greater competition and have proposed means to achieve it.

On the question of the commercial/financial links, however, we believe it is wiser to give priority to concerns about the solvency of the institutions and the stability of financial markets. We adopt this position in the knowledge that in formulating public policy, the provincial and federal authorities must continuously seek to find the right balance between competition and solvency, and that in the new financial environment, dealing with solvency concerns will present a tremendous challenge. Moreover, we believe that many of the benefits of commercial/financial links can be obtained in other ways: synergies can be achieved without cross-ownership; and markets can be competitive without commercial/financial links.

While we favour the second option, we also acknowledge that commercial/financial links already exist within the Canadian financial industry. Consequently, we believe it is appropriate to "grandfather" those existing arrangements. This proposal reflects our view that the commercial owners of financial firms should, over time, reduce their equity interest in their financial partner to a position of less-than-majority ownership.

More than one approach can be taken to achieve that result. One is to allow a suitable transition period in order that current business commitments may proceed. Thereafter, the growth of the assets of these institutions would be frozen until the major investor reduces his investment to a position of less-than-majority ownership. An alternative would be to allow continued asset growth, provided that share ownership is reduced at some fixed pace, whether legislated or negotiated.

We are aware that requiring the controlling shareholders to reduce their ownership to a minority position is more restrictive than the figure of 65 per cent proposed in the federal government's Blue Book. In part, our proposal reflects our general concern about solvency; it also reflects our recognition that even after reducing their shareholding to less than a majority position, "grandfathered" firms would remain in a privileged position relative to other deposit-taking institutions. A less-than-majority position would also enhance the influence of the other shareholders, should a procedure of cumulative voting be put into place, as proposed in the Blue Book. Under this procedure, the number of votes cast by a shareholder would be equal to the number of shares held, multiplied by the number of directors to be elected. As a shareholder can concentrate his vote on one candidate, cumulative voting would increase the chances that the smaller shareholders have of electing board members; that possibility will be the greater, the lower the stake of the major shareholder.

16 We recommend that an investor (an individual or a corporation) with interests in a nonfinancial company not be allowed to own more than 10 per cent of the capital stock of any deposit-taking institution. In the case of deposit-taking institutions that have links with commercial ventures at the time that such a legislative proposal is tabled, the growth of the institution's assets should either:

a) be brought to a halt within a suitable period of time from the implementation of the recommendation, with that growth to be allowed to resume after shareholders with commercial interests have reduced their investment to a position of less than majority ownership; or

b) be allowed to continue to grow unrestricted, subject to agreement with the relevant government authority about a timetable for reducing the majority shareholding to a minority position.

Nondeposit-taking institutions that have commercial links would be required to set up internal review committees made up of independent directors to ensure that transactions with associated nonfinancial firms reflect market conditions.

This recommendation would only specifically apply to Schedule B banks and trust companies, since Schedule A banks and credit unions are widely held and since securities firms, merchant banks, insurance companies, and financial corporations do not accept deposits.

Our recommendation is addressed to both levels of government. In certain provincial jurisdictions, the development of commercial/financial links has been used to strengthen local institutions. The Council recognizes the merits of fostering the growth of solid institutions attuned to local needs. Elsewhere in this Statement, we have offered recommendations that would contribute to that goal. However, we believe that the establishment of commercial/financial links for that purpose would provide short-term gains at the risk of high costs in the longer run. We are also aware that many provincial activities in this area of financial regulation – in particular, the initiatives undertaken by the Quebec government – have contributed to the modernization of Canadian financial markets. While allowing commercial ownership of financial institutions could add further to the competitiveness of this country's financial institutions and markets, on balance we believe that a longer view is called for, taking into account the added risks and the potential drain on public safety nets.

Policies Requiring International Cooperation

Policy makers and regulators must work together to harness the forces that the processes of globalization of markets and the financial innovation have unleashed. First, they must cooperate in removing the remaining impediments to the orderly continuation of the internationalization process, so that residents from all countries can benefit from increased worldwide competition among financial institutions and from better access to markets all around the world. At the same time, they must ensure that no institution can escape supervision by moving its activities from one jurisdiction to another, that international movements of funds are properly tracked, and that competitive regulation does not lead to a lax supervisory system. These measures would contribute to the solvency of financial institutions and to the stability of markets.

Improving Competition and Accessibility

While Recommendations 4 and 5 dealt with the removal of domestic barriers to Canadian participation in global

financial markets, any barriers remaining in other countries also ought to be removed. Accordingly,

17 We recommend that the Canadian government actively encourage other nations to eliminate any remaining barriers to the free cross-border movement of capital.

Among the countries of economic significance to Canada, few legal barriers remain. The Glass-Steagall Act and the MacFadden Act in the United States, the lack of transparency in the application of financial regulation in Japan, limits to the cross-border movement of people imposed by the United States and the United Kingdom are among the more serious obstacles that remain. Some restraints on cross-border capital flows exist in France, where lending to non-residents must be financed by funds deposited by non-residents. There are limits on foreign ownership and acquisition in Thailand, Singapore, and Venezuela; limits on entry in South Korea and Italy; as well as exchange controls in the Philippines and Brazil. According to a 1988 survey of some Canadian financial institutions, conducted by a number of federal government departments (and in which the Economic Council participated), the legal barriers to trade in financial services are seen as being small – more in the nature of an irritant. Most other barriers are economic or cultural in nature and thus are much more difficult to overcome.

Some "technical" aspects of the functioning of financial markets have not kept pace with recent developments and act as an impediment to the efficient operation of international markets. These weaknesses pertain to the clearing or matching of "buy" and "sell" orders and of the settlement (transfer of cash and securities) of transactions. Accordingly,

18 We recommend that Canadian securities commissions work in concert with international organizations towards the establishment of an efficient international structure for the clearing and settlement of orders.

Without efficient and comparable clearing and settlement mechanisms, borrowers and investors will shy away from many foreign markets, and the potential benefits to be drawn from international markets will be lost. A first step would be to establish an efficient clearing and settlement system on dc nestic markets and then to build international links.

Risk Reduction and Systemic Stability

Ensuring the stability of financial institutions and markets in the international context requires a four-pronged approach: the availability and dissemination of appropriate information; the establishment of harmonized accounting and reporting standards; the establishment of standardized capital requirements; and cooperation in prudential supervision. Dealing with the availability of information first,

19 We recommend that securities commissions and stock exchanges in Canada work within the International Organization of Securities Commissions and other international bodies towards ensuring the dissemination of information on stock prices and on the performance of publicly traded companies, as changes occur.

Information should be made available as soon as conditions change. To that effect, appropriate communications systems should first be put into place in individual countries, as recommended in the many reports that investigated the October 1987 stock market crash in the United States and in Europe. Then electronic international linkages between national systems should be developed.

The unbundling of risks, the growth of off-balance-sheet items, and cross-border trading have eroded the quality of the existing data on international financial intermediation. The supervisory authorities need to evaluate the risks constantly; and governments, in the management of their economy, need to know to what extent their nationals call upon international markets for their investment and financing needs. Accordingly,

20 We recommend that the Canadian government cooperate with the governments of the industrialized nations to encourage their statistical bodies to establish databases on international financial transactions.

Examples of the type of data that are currently lacking and that would be useful are: the exposure of institutions abroad to various off-balance-sheet items; the distribution of foreign-currency loans abroad according to the residence status of the borrower; details on the foreign placement of pension funds; details on foreign investments; the income of individuals, corporations, insurance companies, pension funds, and other corporate entities received from abroad, by size, origin, and currency composition.

A second step would be the establishment of common criteria for the reporting of the financial position of financial firms. To that effect,

21 We recommend that the federal and provincial governments and regulators, and Canadian accounting and auditing bodies:

a) endorse the efforts of the International Accounting Standards Committee, the International

Auditing Practices Committee, and the International Organization of Securities Commissions in developing international accounting and auditing standards;

b) actively participate in the development of such standards within the above-mentioned international bodies, with the ultimate goal of adopting them within their own jurisdiction; and

c) urge the above-mentioned international bodies to accelerate the development of international standards for the treatment of the off-balance-sheet exposure of corporations and financial institutions.

The harmonization of accounting practices is no small task, given the differences between nations and the entrenched belief that one's own system is the best. The International Accounting Standards Committee (IASC) has been working for over 15 years towards setting international accounting standards; and the International Auditing Practice Committee, established by the International Federation of Accountants, has been issuing guidelines with respect to auditing practices for 11 years. Neither of these organizations has the power to have its standards override national standards. To be effective, they need the endorsement of national standards-setting bodies and regulators. In Canada, the IASC benefits from the support of the Canadian Institute of Chartered Accountants and of several regulatory authorities.

As the international bodies are still working towards the harmonization of the treatment of on-balance-sheet items – the IASC released a draft paper on that subject in January 1989 – the development of standards in that area is still a number of years away. Delays in dealing with that issue threaten the stability of the financial system, however. Because of the lack of transparency, the financial world could, without warning, be hard-hit by a serious accident.

Harmonized and adequate accounting and auditing standards are a prerequisite for the prudential supervision of financial institutions. But in an increasingly globalized world, harmonization should also cover the control of fraud, self-dealing and abuses of conflict-of-interest situations, and the undertaking of risks by various players. Also, the supervision of multinational financial institutions requires an overall view of their operations. The federal and provincial governments must be able to obtain information from foreign authorities. They must be prepared to provide information on Canadian institutions to regulators in other countries. Consequently,

22 We recommend that federal and provincial governments work in international forums towards improving the international coordination of the prudential supervision of financial institutions. Areas that need improvement include:

a) access to consolidated statements and information from foreign regulators;

b) control of fraud, self-dealing, and abuses of conflict-of-interest situations; and

c) supervision of securities firms and securities trading by banks.

With the rapid development of securitization, more attention must, indeed, be given to securities firms and to securities trading by commercial banks. The world banking system benefited from the work undertaken by the Committee of Bank Supervisors under the aegis of the Bank for International Settlements. In the case of securities firms, however, efforts at coordination only began in 1986-87 under the auspices of the International Organization of Securities Commissions. Although some progress has been achieved, much more remains to be done.

The coordination of the prudential supervision of the securities business is at the same stage of development that coordination in the banking sector was in the early 1970s. Obviously, miracles cannot be achieved here, but there should be a true sense of urgency, which should not, however, serve as an excuse for weak standards. The international coordination of prudential supervision should rely on minimum standards that provide meaningful safeguards. Minimum capital requirements must be an important element of these standards.

23 We recommend that securities commissions in Canada work within the International Organization of Securities Commissions towards the establishment of international risk-weighted capital requirements for securities firms and that the weights vary depending on the firms' exposure to position and credit risks.

This effort should also be coordinated with those of the Committee of Bank Supervisors, so that all of the institutions involved in similar types of activities would face the same capital requirements.

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Borrowers and lenders, like the explorers of outer space, may not always appreciate the potential and the perils that

they encounter in the still largely uncharted territory of the new financial frontier created by the globalization of markets and the development of innovative products. Yet this new frontier has great potential to enhance the efficiency of financial markets and strengthen the performance of the Canadian economy. It offers cheaper services and more diversified sources of funding. Producers and users who shy away from the frontier stand to lose out to their more venturesome competitors.

The Economic Council believes that the changes outlined in its recommendations are needed if Canadians are to garner the benefits of the new financial environment while reducing the associated risks. Thus we believe that barriers to innovation and restrictions on international transactions should be removed. We also believe that securitized business loans, if prudently managed, will increase the efficiency of the economy and serve the financial needs of borrowers in the regions outside central Canada.

For Canadian-based financial institutions, the new frontier offers many new opportunities within a much more competitive environment. We realize that these institutions have been losing share in some rapidly growing markets. We believe that strong Canadian-based institutions are important for our collective future. But we also believe that competition, not protectionism, is the best way to develop their strength. Hence we suggest a further relaxation in the restrictions on foreign competition in the domestic market; and we propose other measures that have the potential to enable Canadian institutions to expand their markets, both in Canada and overseas. If implemented, these measures are likely to accelerate the restructuring of the financial-services industry. This restructuring is an essential prerequisite to remaining competitive in the marketplace of tomorrow.

While our recommendations give greater emphasis to promoting competition, they are also aimed at strengthening the solvency of our financial institutions and the stability of the domestic and international financial systems. If measures along these lines are implemented, we believe that the risks unleashed by the new financial frontier can be managed; and as a result there will be greater scope for more economic gains.

We are convinced that internationalization will continue. No shield can isolate Canadians from current international developments. Therefore, we believe that Canadians, and their governments, must seize the initiative; they must adjust the controls of the ship of state to guide our voyage through the new financial frontier.

Dissent from Recommendation 16

*Tom Courchene**

I support all of the Council's recommendations, with one important exception: in my view, Recommendation 16 does not square well with the thrust of the earlier analysis in the document. There, the emphasis was on the financial-services explosion and the growth of the global financial-services industry, with explicit reference to the fact that Canadian institutions have fallen substantially in terms of international size rankings and that in several areas, this has resulted in a falling share of the Canadian financial-services business being done by Canadian institutions. What was perhaps not emphasized sufficiently was that, initially at least, most of the innovations came from non-banks – securities firms, "in-house" corporate banks, and organizations like GMAC, which issued the first Euro-market securitized offering. This is hardly surprising, since the underlying nature of the innovations was to shift from intermediated finance to various forms of "direct" finance – i.e., away from traditional banking and towards the activities that one normally associates with securities firms. Hence, the mushrooming of the so-called "off-balance-sheet" activity as the world's banks moved into the traditional securities industry areas. While some of the bloom has been eroded from global finance in the wake of the 1987 crash, the fact remains that financial-services investment is still on the cutting edge of the computational and telecommunications revolutions. Hence it is not surprising that the computer and telecommunications giants as well as multinationals are entering the industry – e.g., Reuters, AT&T, BP, GMAC, and now, perhaps, Bell Enterprises. This perspective is important since the financial-services explosion and the so-called "big bangs" are about much more than banks and old-style banking. Indeed, they are essentially about the move from commercial banking towards investment banking.

The issue then becomes: how should Canadian policy approach all of this? My view is that we should be guided by two principles. First, in an era of rapid innovation and globalization of the financial sector, any action or innovation ought to be viewed as acceptable unless it can be demonstrated to be contrary to the public interest – i.e., the "burden of proof" should be placed on those who wish to retain the status quo, not on the innovators. The Council's document seems to me to argue from the other vantage point: the status quo somehow acquires "virtue," and those who want to bring new capital into the financial sector must prove that the 10-per-cent rule is inappropriate. For example, there is little or no reference in the text to the fact that the introduction of the 10-per-cent rule was driven more by concerns about foreign ownership than by concerns about self-dealing. Except for one oblique reference, there is no recognition of the fact that director self-dealing can be every bit as problematical as shareholder self-dealing. Nor is there any mention of the conflict-of-interest potential when a nationwide bank owns a nationwide securities firm let alone of the fact that if one can be satisfied that regulators can handle these potential conflicts of interests, then those which are associated with commercial links, particularly when the institutions are large, are in my view regulatorily trivial by comparison.

The second operating principle in this area ought to be that Canadian firms be treated on a par with foreign firms. Here, I am speaking more as a Canadian than as an economist, so that what follows is a personal, not professional, argument. The fact that Lloyds Bank and the Hongkong Bank were allowed to buy faltering Canadian banks but Power Corporation and the Royal Trust group were excluded "on principle" does not make sense. What is the operating logic here? That we have more confidence in whoever regulates these international banking conglomerates than in our ability to regulate Power Corporation and other domestic firms? More recently, Bell Enterprises was not allowed to buy the Commerce Group. It went to a firm from the Netherlands – a jurisdiction that permits both upstream and downstream commercial links in the financial sector. What sense does this make for a country where foreign ownership is already viewed as a concern? Where is the discussion of this issue in the Council's document?

Even more to the point, Ottawa has now granted American Express a Schedule B charter (delayed by one year), even though Amex has commercial links *in Canada* – and Bell Enterprises (widely held, but with commercial links) has made a bid to purchase Montreal Trust. Both of these run afoul of Recommendation 16. From my perspective, the former poses many more problems than the latter. This aside,

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* Marcel Pepin endorses Mr. Courchene's position.

both are probably signalling new directions in financial-ownership policy. How can the Council avoid comment on these developments (except indirectly, in the sense that Recommendation 16 would prohibit both)?

Over the past decade or so, Quebec has made incredible strides in terms of developing a viable financial-institutions sector. In the West, however, the dossier has been one of failure after failure. With the advent of securitization, financial institutions can now diversify their asset portfolio outside their own region, so that the concept of western banks or financial institutions becomes more viable. Recommendation 16, by prohibiting new capital from commercial sources (except in 10-per-cent tranches) from entering deposit-taking institutions in the financial arena probably means that this will remain conceptually possible but practically unrealizable.

Implementing those two principles should provide a more appropriate framework for restructuring the financial sector. It may well be that prohibition of commercial links will end up as the appropriate policy, but this must be argued analytically rather than assumed by ascribing virtue to the status quo. In particular, the document makes far too much of the presumed link between commercial interests and insolvency. The comment that in the presence of commercial links the deposit-insurance authorities may end up bailing out the commercial firm rather than the financial institution is, of course, possible. But isn't this what the Dome bailout was all about? And aren't the Canadian taxpayers in the process of bailing out the banks for their Latin American excesses, and aren't the G-7 members cutting deals with the Latin American countries to keep the banks afloat? In other words, 10-per-cent ownership is hardly synonymous with solvency. The real issues here relate to the role of the CDIC and to corporate governance. Canadians seem singularly unwilling to bite the bullet here and, as a result, tend to fall back on tackling some of the presumed symptoms, such as commercial links.

None of this is meant to argue against some sort of limitation with respect to commercial links and wide ownership. However, the 10-per-cent rule appears to have substantially been overtaken by events over the past several years and, in my view, it is no longer in the set of feasible solutions. My preference is for the approach laid out in the Senate Reports on both ownership and deposit insurance. This is particularly the case now that Quebec appears to be embracing this position.

My final general comment relates to the broader policy arena in which Recommendation 16 is embedded. The document argues that the principal issue relates to upstream commercial links (i.e., whether the commercial sector can own the financial sector) and not downstream links (whether the financial can own the commercial). Yet it is the latter that is the emerging issue. Motivated by the takeover binge, Quebec recently signalled its intention to allow Quebec financial institutions to buy into commercial enterprises. Both the Caisse de dépôts and the caisses populaires have indicated that they will conduct their activities with an eye to ensuring that the jewels of the real sector remain Quebec-based. These are among the types of activities undertaken by universal banks. Will Ottawa follow suit when the next takeover falls into their lap? Is this the policy avenue down which we ought to be headed? We need an immediate national debate on the many issues (foreign ownership, competition policy, asset concentration) that are subsumed in the commercial-links/financial-institutions-ownership nexus. While I could well be wrong, it does not strike me as particularly useful to begin this difficult policy debate by harking back to the 10-per-cent rule.

Glossary

Arbitrage. A trading strategy whereby the same asset is simultaneously bought on market A and sold on market B in order to take advantage of a presumed price difference between those two markets.

Asset-backed securities (ABSs). Securities created by gathering a number of assets (such as mortgage, car, or commercial loans) into a pool and issuing certificates of participation in that pool to investors. Each certificate represents a claim on the pooled assets, which act as collateral.

Bank for International Settlements. An international organization of central banks, established in 1930 to handle war reparation payments. It now acts as a provider of short-term liquidity to central banks in need, operates the private ECU (European currency unit) clearing and settlements system, and acts as agent for several organizations of the European Community. It is a major forum for promoting cooperation among central banks and other international organizations.

"Big Bang." Name given to the institutional changes that took place on the London stock market on 27 October 1986. Those changes mainly involved the liberalization of the securities industry by: freeing access to the stock exchange; permitting the ownership of securities firms by nonindustry participants; removing minimum commissions; and removing the functional separation between brokers fulfilling client orders and those operating on their own account. The "Big Bang" is a symbol of financial deregulation, although most of the regulatory changes in the United Kingdom actually occurred when the new Financial Services Act was passed.

Bretton Woods Agreement. An international agreement – signed at Bretton Woods, New Hampshire, in July 1944 by the representatives of 44 nations – that established a system of fixed parities between the currencies of the participating countries and the U.S. dollar.

Clearing mechanism. An organized system used by financial institutions to transfer securities or payment orders (such as cheques) among themselves.

Collateralized mortgage obligations. A form of asset-backed security created by pooling mortgages and issuing four classes of securities – A, B, C, and Z – which are sold to investors. The cash flow generated from the mortgage pool is first used to pay the interest to the first three classes – A, B, and C – and then to repay the principal of the A class until this class is completely retired. The same procedure then applies to the B and C classes, in that order. The Z class does not receive any principal or interest until all previous classes have been retired.

Commercial paper. A short-term debt instrument issued by a corporation, usually carrying a maturity of 30, 90, or 180 days.

Counterparty. A party on one side of a transaction; for example, the counterparties to a personal bank loan are the bank and the borrower.

Credit risk. The risk that a counterparty to a contract (a borrower, for example) may fail to live up to the terms of the contract – usually with respect to the payment of the interest or the principal, or both.

Cross-pillar diversification. The expansion of institutions in one "pillar" into activities of another "pillar," either directly or through ownership of an institution in another "pillar." Examples are the provision of deposit-taking services (a banking function) by trust companies and the ownership of securities firms by banks.

Currency swap. A transaction in which interest payments in one currency are traded for an interest payment in another. The parties may also exchange the principal amount at a negotiated exchange rate. At maturity, the principal amount may be exchanged back at a pre-arranged exchange rate.

Eurobonds. Bonds issued simultaneously in more than one country.

Euro-commercial paper (ECP). A short-term debt instrument, issued directly by a corporation on the Euro-market and carrying a maturity of 7 to 365 days; Euro-commercial paper is issued in high denominations – usually a minimum of $100,000 – and is usually underwritten by a bank or a securities firm. Unlike note-issuance facilities, however, Euro-commercial paper carries no safeguard for the issuer, other than an undertaking by the intermediary to place the paper on a best-effort basis.

Floating-rate notes (FRNs). A long-term debt instrument carrying a floating rate of interest, which is reset periodically in relation to some independent interest rate – typically the London interbank borrowing rate (LIBOR).

Forward contract. An agreement between two parties to exchange a specified amount and type of commodity or financial instrument at a future date at a predetermined price.

Forward rate agreement. An agreement whereby the counterparties (usually a bank and its customer) set an interest rate for a predetermined date in the future on a hypothetical (notional) amount of principal.

Futures contract. A contract, usually traded on an organized exchange, that confers the right and the obligation to buy a specific commodity or currency at a fixed date and at a predetermined price.

Glass-Steagall Act. The U.S. Banking Act, adopted in 1933, which established, among other things, the principle of separation of banking from securities activities.

Hedging. The taking of a position to reduce risk by offsetting existing or anticipated exposure to a change in market prices.

Interest-rate swap. A transaction in which two counterparties exchange interest payments on a hypothetical (notional) principal amount. The main types of swap are: a fixed-rate instrument for a floating-rate instrument in the same currency; one floating-rate index for another floating-rate index in the same currency; and a fixed-rate instrument in one currency for a floating-rate instrument in another.

Issue. This term can be used with two different meanings: 1) the offering for sale of a new series of stock or bond by a corporation, government, or institution; and 2) a security outstanding.

Letter of credit. A commitment by a bank or some other financial institution to pay a certain sum of money on demand on behalf of a client who pays a fee for this guarantee.

Market maker. A market participant, usually a financial institution, that stands ready to buy – or to sell out of its own inventory – a specific asset, so that the asset can always be traded by other market participants. The market maker earns a profit from the difference between the buying and selling prices. Market-making activity maintains liquidity in the asset, reduces its riskiness, and makes it a more attractive investment.

Mortgage-backed bonds. Bonds issued by a mortgage company, mainly in the United States, which pay interest at regular intervals and repay the principal either periodically or at maturity. These are asset-backed securities in which a pool of mortgage loans acts as collateral; however, the bonds remain a direct liability of the issuing company, and the loans remain on the book of the originator.

Mortgage-backed securities. Asset-backed securities based on a pool of mortgages.

Mortgage pass-throughs (MPTs). A form of mortgage-backed security, in which interest and redemption payments on the mortgages received by the pool are redistributed to the certificate holder at the prorata of their share in the pool.

National treatment. In trade negotiations, an agreement between the parties that foreign and domestic institutions will be treated in exactly the same fashion by the host country.

Note-issuance facilities (NIFs). A medium-term (i.e., five to seven years) binding commitment, under which a borrower can issue short-term paper in its own name with a maturity of three to six months. The facility is generally underwritten by a bank, and the bank normally undertakes to extend credit to the issuer or to buy its notes if they cannot be sold at an agreed-upon minimum price.

Off-balance-sheet activity. The share of the business of financial institutions that does not involve the reporting of assets or liabilities on the balance sheet. This activity is generally of the type that creates a contingent liability for the institution.

Options contract. A contract that gives the holder the right, but not the obligation, to buy or to sell a specified amount of a commodity, financial asset, or currency at a predetermined price – or, in the case of an interest-rate option, to fix the interest rate at a specified future date on a hypothetical (notional) amount.

Originator. The institution or lender that originally extends a loan to a borrower.

Over-the-counter transactions. Trading in financial instruments that is conducted outside of organized exchanges. These transactions include bank loans, swaps, and so on.

Perpetual floating-rate notes. Floating-rate notes issued mainly by banks and corporations, without a set redemption date.

"Pillar." Group of institutions performing a major financial function. The Canadian financial system is often described as consisting of four "pillars": banks, trust companies, insurance companies, and securities dealers.

Position risk or *price risk.* The risk that the financial position of a market participant will be adversely affected by a change in interest or exchange rates if its assets and liabilities are not matched with respect to interest-rate structure or currency composition.

Private pension plan. A pension plan sponsored by an employer (in either the private or the public sector) or by a union for its members. Private plans include: trusteed pension plans, in which funds collected from employees and employers are managed by a trustee; insured plans, where the funds collected are merged with an insurance company's insurance funds; registered retirement savings plans (RRSPs); and some government employee plans where funds are held by governments in their consolidated revenue accounts. By contrast, public pension plans are provided by governments to all residents who qualify by reason of age or income or both. They include the Canada and Quebec Pension Plans, Old Age Security, and Guaranteed Income Supplement.

Prospectus. A legal document prepared by a corporation as a prerequisite to a bond or stock issue. It describes the conditions of the issue and provides information on the corporation. A prospectus must be filed with most securities commissions before they will allow a corporation to offer its securities for public sale.

Reciprocity. In trade negotiations, the exchange of concessions to the mutual, equal advantage of each party. This differs from "national treatment" (q.v.) in that under the latter, an institution from one country can do in the host country whatever the host country's own institutions can do, whereas under reciprocity, the emphasis is on each country giving concessions of equal value.

Securitization. This term is used with two meanings: 1) the direct issue of securities by corporate borrowers; and 2) the repackaging of mortgage, credit-card, or car loans into securities pools through the issuance of asset-backed securities. In the first meaning, securitization refers to the increased use of traditional securities – such as bonds – and a variety of new negotiable instruments such as NIFs, FRNs, and Euro-commercial paper. In the second meaning, it refers to the conversion of loans or receivables into negotiable instruments, which are then offered to investors.

Settlements mechanism. An organized system used by financial institutions to effect final payments for transactions.

Swap. A financial transaction in which two parties agree to exchange streams of payments over time, according to a predetermined rule. See "currency swaps" and "interest-rate swaps."

Thrift. Regional banking institutions in the United States, consisting of credit unions, mutual saving banks, and savings and loan associations. Thrifts are the major group of institutions originating mortgages in the United States.

Underwriting. The process by which securities or insurance policies are issued.

List of Supporting Documents

Economic Council of Canada	"Globalization and Canada's Financial Markets," a research report (forthcoming)
Mayrand, A.	"Concentration in Canadian financial markets: An update"
Nigam, A.	"Canadian corporations, financial innovation and international capital markets: A survey"
Patterson, K.	"Coordination of macroeconomic policies"
Ryba, A.	"The securitization of business loans"
Zayat, H.	"Canadian borrowers and Canadian financial institutions in international markets"

Research Team

André Ryba, project director
Keith Patterson

Andrée Mayrand
Pierre Mercier
Ashok Nigam
Hani Zayat

Carole Morris, secretary

Economic Council
of Canada

Conseil économique
du Canada